

EXAMINATION FREQUENCY GUIDELINES FOR STATE MEMBER BANKS

The Federal Reserve is required to conduct a full-scope, on-site examination of every insured member bank at least once during each 12-month period, with the exception that certain small institutions can be examined once during each 18-month period. The 18-month examination period can be applied to those banks that—

- have total assets of \$250 million or less;
- are well capitalized;
- were found to be well managed at the most recent Federal Reserve examination;
- were determined to be in outstanding or good condition at the most recent Federal Reserve examination, that is, they received a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System;
- are not subject to a formal enforcement proceeding or action; and
- have not had a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for these exceptions.

These exceptions do not limit the authority of the Federal Reserve to examine any insured member bank as frequently as deemed necessary. (See SR-97-8.) The examination frequency is also affected by the alternate-year examination program. Banks that are excluded from this program are those institutions that are \$10 billion or greater in size and rated a composite 3 or worse, and de novo banks until they are rated 1 or 2 for two consecutive examinations after they have commenced operations. Also, a bank that undergoes a change in control must be examined by the Federal Reserve within 12 months of the change in control. Under the alternate-examination program, those banks that qualify are examined in alternate examination cycles by the Reserve Bank and the state. Thus, a particular bank would be examined by the Reserve Bank in one examination cycle, the state in the next, and so on. Any bank may be removed from the program and examined at any time by either agency, and either agency can meet with a bank's management or board of directors or initiate supervisory action whenever deemed necessary.

EXAMINATION OF INSURED DEPOSITORY INSTITUTIONS BEFORE THEY BECOME OR MERGE INTO STATE MEMBER BANKS

Pre-membership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state membership status will not be required if the bank or savings association seeking membership meets the criteria for "eligible bank," as defined in section 208.2(e) of Regulation H.¹ Additionally, examinations of state nonmember banks, national banks, and savings associations seeking to merge into a state member bank will not be required so long as the state member bank, on an existing and pro forma basis, meets the criteria for "eligible bank."

For those institutions not subject to a pre-membership or pre-merger examination, risk assessments and supervisory strategies should be completed no later than 30 days after the conversion or merger. To the extent issues or concerns arise, targeted or, if warranted, full-scope examinations of the converted or merged institution should be conducted as soon as possible after the conversion or merger. For a state member bank that was formerly a savings association or that acquired a savings association, the risk assessment and supervisory strategy should pay particular attention to activities conducted by a service corporation subsidiary that may not be permissible activities for a state member bank.

Pre-membership or pre-merger examinations should generally be conducted for an insured depository institution that does not meet the criteria for eligible bank. Consistent with a risk-focused approach, these examinations can be targeted, as appropriate, to the identified area(s) of weakness. The Reserve Bank may, in its discretion, waive the examination requirement if it is determined that conducting an

1. "Eligible bank" is defined to mean a member bank that (1) is well capitalized; (2) has a composite CAMELS rating of 1 or 2; (3) has a CRA rating of "outstanding" or "satisfactory"; (4) has a compliance rating of 1 or 2; and (5) has no major unresolved supervisory issues outstanding, as determined by the Board or appropriate Federal Reserve Bank in its discretion. A major unresolved supervisory issue could also arise from significant trust or fiduciary activities that are found to be conducted in a less than satisfactory manner.

examination would be (1) inconsistent with a risk-focused approach and/or (2) unlikely to provide information that would assist materially in evaluating the statutory and regulatory factors that the Federal Reserve is required to consider in acting on the membership or merger application.² If an examination is waived, the Reserve Bank should prepare and maintain documentation supporting its decision.

In all circumstances, each Reserve Bank is responsible for ensuring that the examination frequency timeframes established by Federal Reserve policy and section 111 of FDICIA are adhered to. When the statutory deadline for an examination of a depository institution seeking membership is approaching or has passed, a Federal Reserve examination of the institution should be conducted as soon as practicable after the institution becomes a state member bank. (See SR-98-28.)

OBJECTIVES OF THE SUPERVISORY PROCESS

The Federal Reserve is committed to ensuring that the supervisory process for all institutions under its purview meets the following objectives:

- *Provides flexible and responsive supervision.* The supervisory process is dynamic and forward looking so that it responds to technological advances, product innovation, and new risk-management systems and techniques, as well as to changes in the condition of an individual financial institution and to market developments.
- *Fosters consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. The supervisory process uses examiner resources effectively by using the institution's internal and external risk-assessment and -monitoring

systems, making appropriate use of joint and alternating examinations, and tailoring supervisory activities to an institution's condition, risk profile, and unique characteristics.

- *Promotes the safety and soundness of financial institutions.* The supervisory process effectively evaluates the safety and soundness of banking institutions, including the assessment of risk-management systems, financial condition, and compliance with laws and regulations.
- *Provides a comprehensive assessment of the institution.* The supervisory process integrates specialty areas (for example, information technology systems, trust, capital markets, and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

RISK-FOCUSED EXAMINATIONS

Historically, examinations relied significantly on transaction-testing procedures when assessing a bank's condition and verifying its adherence to internal policies, procedures, and controls. In a highly dynamic banking market, however, transaction testing by itself is not sufficient for ensuring the continued safe and sound operation of a banking organization. Evolving financial instruments and markets have enabled banking organizations to rapidly reposition their portfolio risk exposures. Therefore, periodic assessments of the condition of a financial institution based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in financial risk profiles.

To ensure that institutions have in place the processes necessary to identify, measure, monitor, and control risk exposures, examinations have increasingly emphasized evaluating the appropriateness of these processes, evolving away from a high degree of transaction testing. Under a risk-focused examination approach, the degree of transaction testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. However, when risk-management processes or internal controls are considered inappropriate, such as by an inadequate segregation of duties or when on-site testing determines processes to be lacking, additional transaction testing must be performed. Testing should be

2. Since membership in the Federal Reserve System does not confer deposit insurance, the membership applications do not include the requirements of the Community Reinvestment Act (CRA). Nevertheless, a less than satisfactory CRA rating, especially if it reflects a chronic record of weak CRA performance, would presumably reflect poorly upon the abilities of the institution's management. Consequently, a determination whether or not to conduct a pre-membership CRA examination should be based upon a risk-focused assessment of the issues involved, with an institution's CRA performance being only one of the factors considered from a risk-focused perspective.

sufficient to fully assess the degree of risk exposure in a particular function or activity. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then substantial on-site transaction testing should be performed.

Compliance with Laws and Regulations

Compliance with relevant laws and regulations should be assessed at every examination. The steps taken to complete these assessments will vary depending on the circumstances of the institution subject to review. When an institution has a history of satisfactory compliance with relevant laws and regulations or has an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. At institutions with a less satisfactory compliance record or that lack a compliance function, more extensive review will be necessary.

RISK-MANAGEMENT PROCESSES AND INTERNAL CONTROLS

The Federal Reserve has always placed significant supervisory emphasis on the adequacy of an institution's management of risk, including its system of internal controls, when assessing the condition of an organization. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe and unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing a banking institution, including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. (See SR-97-24 and SR-97-25.)

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as

interest rates, foreign-exchange rates, or equity prices.

- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding-liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market-liquidity risk").
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- *Reputational risk* is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

In practice, an institution's business activities present various combinations and concentrations of these risks depending on the nature and scope of the particular activity. The following discussion provides guidelines for determining the quality of bank management's formal or informal systems for identifying, measuring, and containing these risks.

Elements of Risk Management

When evaluating the quality of risk management as part of the evaluation of the overall quality of management, examiners should consider findings relating to the following elements of a sound risk-management system:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk-measurement, -monitoring, and management information systems
- comprehensive internal controls

Adequate risk-management programs can vary

considerably in sophistication, depending on the size and complexity of the banking organization and the level of risk that it accepts. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. However, large, multinational organizations will require far more elaborate and formal risk-management systems to address their broader and typically more complex range of financial activities, and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. In addition to the banking organization's market and credit risks, risk-management systems should also encompass the organization's trust and fiduciary activities, including investment advisory services, mutual funds, and securities lending.

Active Board and Senior Management Oversight

When assessing the quality of the oversight by boards of directors and senior management, examiners should consider whether the institution follows policies and practices such as those described below:

- The board and senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the institution's activities evolve.
- The board has reviewed and approved appropriate policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board and management are sufficiently familiar with and are using adequate record-keeping and reporting systems to measure and monitor the major sources of risk to the organization.
- The board periodically reviews and approves risk-exposure limits to conform with any changes in the institution's strategies, reviews new products, and reacts to changes in market conditions.

- Management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise is consistent with the nature and scope of the banking organization's activities.
- Management ensures that the depth of staff resources is sufficient to operate and soundly manage the institution's activities, and ensures that employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- Management at all levels provides adequate supervision of the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, management identifies and reviews all risks associated with the activities or products and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

Adequate Policies, Procedures, and Limits

Examiners should consider the following when evaluating the adequacy of a banking organization's policies, procedures, and limits:

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the institution's activities.
- Policies provide for the review of new activities to ensure that the financial institution has the necessary infrastructures to identify, monitor, and control risks associated with an activity before it is initiated.

Adequate Risk Monitoring and Management Information Systems

When assessing the adequacy of an institution's risk measurement and monitoring, as well as its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk-monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented, and are tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the banking organization's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
- Reports to management or to the institution's directors are accurate and timely, and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution.

Adequate Internal Controls

When evaluating the adequacy of a financial institution's internal controls and audit procedures, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties throughout the organization—such as duties relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely, and, when

applicable, exceptions are noted and promptly investigated.

- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed. The coverage of, procedures for, and findings and responses to audits and review tests are adequately documented. Identified material weaknesses are given appropriate and timely high-level attention, and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's audit committee or board of directors reviews the effectiveness of internal audits and other control-review activities regularly.

RISK-FOCUSED SUPERVISION OF COMMUNITY BANKS

Understanding the Bank

The risk-focused supervision process for community banks involves a continuous assessment of the bank, which leads to an understanding of the bank that enables examiners to tailor their examination to the bank's risk profile. In addition to examination reports and correspondence files, each Reserve Bank maintains various surveillance reports that identify outliers when a bank is compared to its peer group. Review of this information helps examiners identify a bank's strengths and vulnerabilities, and is the foundation for determining the examination activities to be conducted.

Contact with the organization is encouraged to improve the examiners' understanding of the institution and the market in which it operates. A pre-examination interview or visit should be conducted as a part of each examination. This meeting gives examiners the opportunity to learn about any changes in bank management and changes to the bank's policies, strategic direction, management information systems, and other activities. During this meeting, particular emphasis should be placed on learning about the bank's new products or new markets it may have entered. The pre-examination interview or visit also provides examiners with (1) management's view of local economic conditions,

(2) an understanding of the bank's regulatory compliance practices, and (3) its management information systems and internal and/or external audit function. In addition, Reserve Banks should contact the state banking regulator to determine whether it has any special areas of concern that examiners should focus on.

Reliance on Internal Risk Assessments

As previously discussed in the subsection "Risk-Management Processes and Internal Controls," the entire spectrum of risks facing an institution should be considered when assessing a bank's risk portfolio. Internal audit, loan-review, and compliance functions are integral to a bank's own assessment of its risk profile. If applicable, it may be beneficial to discuss with the bank's external auditor the results of its most recent audit for the bank. Such a discussion gives the examiner the opportunity to review the external auditor's frequency, scope, and reliance on internal audit findings. Examiners should consider the adequacy of these functions in determining the risk profile of the bank, and be alert to opportunities to reduce regulatory burden by testing rather than duplicating the work of internal and external audit functions. See the subsection "Risk-Focused Examinations" for a discussion on transaction testing.

Preparation of a Scope Memorandum

An integral product in the risk-focused methodology, the scope memorandum identifies the central objectives of the examination. The memorandum also ensures that the examination strategy is communicated to appropriate examination staff, which is of key importance, as the scope will likely vary from examination to examination. Examination procedures should be tailored to the characteristics of each bank, keeping in mind its size, complexity, and risk profile. Procedures should be completed to the degree necessary to determine whether the bank's management understands and adequately controls the levels and types of risk that are assumed. In addition, the scope memorandum should address the general banking environment, economic conditions, and any changes foreseen by bank management that could affect

the bank's condition. Some of the key factors that should be addressed in the scope memorandum are described below.

Preliminary Risk Assessment

A summary of the risks associated with the bank's activities should be based on a review of all available sources of information on the bank, including, but not limited to, prior examination reports, surveillance reports, correspondence files, and audit reports. The scope memorandum should include a preliminary assessment of the bank's condition and major risk areas that will be evaluated through the examination process. For detailed discussion of risk assessments and risk matrices, see the subsection "Risk-Focused Supervision of Large, Complex Institutions."

Summary of Pre-Examination Meeting

The results of the pre-examination meeting should be summarized. Meeting results that affect examination coverage should be emphasized.

Summary of Audit and Internal Control Environment

A summary of the scope and adequacy of the audit environment should be prepared, which may result in a modification of the examination procedures initially expected to be performed. Activities that receive sufficient coverage by the bank's audit system can be tested through the examination process. Certain examination procedures could be eliminated if their audit and internal control areas are deemed satisfactory.

Summary of Examination Procedures

As discussed below, examination modules have been developed for the significant areas reviewed during an examination. The modules are categorized as primary or supplemental. The primary modules must be included in each examination. However, procedures within the primary modules can be eliminated or enhanced based on the risk assessment or the adequacy of the audit and internal control environment. The scope memorandum should specifically detail the areas within

each module to be emphasized during the examination process. In addition, any supplemental modules used should be discussed.

Summary of Loan Review

Based on the preliminary risk assessment, the anticipated loan coverage should be detailed in the scope memorandum. In addition to stating the percentage of commercial and commercial real estate loans to be reviewed, the scope memorandum should identify which specialty loan reference modules of the general loan module are to be completed. The memorandum should specify activities within the general loan module to be reviewed, as well as the depth of any specialty reviews.

Job Staffing

The staffing for the examination should be detailed. Particular emphasis should be placed on ensuring that appropriate personnel are assigned to the high-risk areas identified in the bank's risk assessment.

is required to complete the expanded analysis for those decision factors that present the greatest degree of risk for the bank. On the other hand, if the risks are properly managed, the examiner can conclude the review.

The expanded analysis provides guidance for determining if weaknesses are material to the bank's condition and if they are adequately managed. If the risks are material or inadequately managed, the examiner is directed to perform an impact analysis to assess the financial impact to the bank and whether any enforcement action is necessary.

The use of the modules should be tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module should be completed will vary from bank to bank. The individual procedures presented for each level are meant only to serve as a guide for answering the decision factors. Not every procedure requires an individual response, and not every procedure may be applicable at every community bank. Examiners should continue to use their discretion when excluding any items as unnecessary in their evaluation of decision factors.

Examination Modules

Standardized electronic community bank examination modules have been developed and designed to define common objectives for the review of important activities within institutions and to assist in the documentation of examination work. It is expected that full-scope examinations will use these modules.

The modules establish a three-tiered approach for the review of a bank's activities: the first tier is the core analysis, the second tier is the expanded review, and the final tier is the impact analysis. The core analysis includes a number of decision factors which should be considered collectively, as well as individually, when evaluating the potential risk to the bank. To help the examiner determine whether risks are adequately managed, the core analysis section contains a list of procedures that may be considered for implementation. Once the relevant procedures are performed, the examiner should document conclusions in the core analysis decision factors. When significant deficiencies or weaknesses are noted in the core analysis review, the examiner

RISK-FOCUSED SUPERVISION OF LARGE, COMPLEX INSTITUTIONS

The Federal Reserve recognizes a difference in the supervisory requirements for community banks and large, complex banking organizations (LCBOs). The complexity of financial products, sophistication of risk-management systems (including audit and internal controls), management structure, and geographic dispersion of operations are but a few of the areas in which large institutions may be distinguished from community banks. While close coordination with state banking departments, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) is important for fostering consistency among banking supervisors and reducing the regulatory burden for community banks, it is critical for large, complex banking organizations.

The examination approaches for both large, complex institutions and community banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, development of a supervisory plan, and examination procedures tailored to the

risk profile. However, the two approaches are implemented differently: the process for complex institutions relies more heavily on a central point of contact and detailed risk assessments and supervisory plans before the on-site examination or inspection. In comparison, for small or noncomplex institutions and community banks, risk assessments and examination activities may be adequately described in the scope memorandum.

Key Elements

To meet the supervisory objectives discussed previously and to respond to the characteristics of large institutions, the framework for risk-focused supervision of large, complex institutions contains the following key elements:

- *Designation of a central point of contact.* Large institutions typically have operations in several jurisdictions, multiple charters, and diverse product lines. Consequently, the supervisory program requires that a “central point of contact” be designated for each institution to facilitate coordination and communication among the numerous regulators and specialty areas.
- *Review of functional activities.* Large institutions are generally structured along business lines or functions, and some activities are managed on a centralized basis. As a result, a single type of risk may cross several legal entities. Therefore, the supervisory program incorporates assessments along functional lines to evaluate risk exposure and its impact on safety and soundness. These functional reviews will be integrated into the risk assessments for specific legal entities and used to support the supervisory ratings for individual legal entities.³
- *Focus on risk-management processes.* Large institutions generally have highly developed risk-management systems, such as internal audit, loan review, and compliance. The supervisory program emphasizes each institution’s responsibility to be the principal source for detecting and deterring abusive and

unsound practices through adequate internal controls and operating procedures. The program incorporates an approach that focuses on and evaluates the institution’s risk-management systems, yet retains transaction testing and supervisory rating systems such as CAMELS, BOPEC, and ROCA. This diagnostic perspective is more dynamic and forward looking because it provides insight into how effectively an institution is managing its operations and how well it is positioned to meet future business challenges.

- *Tailoring of supervisory activities.* Large institutions are unique, but all possess the ability to quickly change their risk profiles. To deliver effective supervision, the supervisory program incorporates an approach that tailors supervisory activities to the risk profile of an institution. By concentrating on an institution’s major risk areas, examiners can achieve a more relevant and penetrating understanding of the institution’s condition.
- *Emphasis on ongoing supervision.* Large institutions face a rapidly changing environment. Therefore, the supervisory program emphasizes ongoing supervision through increased planning and off-site monitoring. Ongoing supervision allows for timely adjustments to the supervisory strategy as conditions change within the institution and economy.

Covered Institutions

For purposes of the risk-focused supervision framework, large, complex institutions generally have (1) a functional management structure, (2) a broad array of products, (3) operations that span multiple supervisory jurisdictions, and (4) consolidated assets of \$1 billion or more.⁴ These institutions may be state member banks, bank holding companies (including their non-bank and foreign subsidiaries), and branches and agencies of foreign banking organizations. However, if an institution with consolidated assets totaling \$1 billion or more does not have these characteristics, the supervisory process adopted for community banks may be more appropriate. Conversely, the complex-institution process may be appropriate for some organiza-

3. When functions are located entirely in legal entities that are not primarily supervised by the Federal Reserve, the results of supervisory activities conducted by the primary regulator will be used to the extent possible to avoid duplication of activities.

4. Large institutions are defined differently in other regulatory guidance for regulatory reports and examination mandates.

tions with consolidated assets less than \$1 billion.

Nonbank subsidiaries of large, complex domestic institutions are covered by the supervisory program. These institutions include nonbank subsidiaries of the parent bank holding company and those of the subsidiary state member banks; the significant branch operations, primarily foreign branches, of state member banks; and subsidiary foreign banks of the holding company. The level of supervisory activity to be conducted for nonbank subsidiaries and foreign branches and subsidiaries of domestic institutions should be based on their individual risk levels relative to the consolidated organization or the state member bank. The risk associated with significant nonbank subsidiaries or branches should be identified as part of the consolidated risk-assessment process. The scope of Edge Act corporation examinations should also be determined through the risk-assessment process. In addition, specialty areas should be included in the planning process in relation to their perceived level of risk to the consolidated organization or to any state member bank subsidiary.

Coordination of Supervisory Activities

Many large, complex institutions have interstate operations; therefore, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, district Reserve Banks have been assigned roles and responsibilities that reflect their status as either the responsible Reserve Bank (RRB) with the central point of contact or the local Reserve Bank (LRB).

LRBs and host states will not routinely examine branches of state member banks or issue separate ratings and reports of examination. Similar to the relationship between the RRBs and LRBs, home-state supervisors⁵ will coordi-

nate the activities of all state banking departments and will be the state's principal source of contact with federal banking agencies and with the bank itself. Also, host states will not unilaterally examine branches of interstate banks.

The RRB is responsible for designating the central point of contact and for ensuring that all aspects of the supervisory process are fully coordinated with LRB and home-state supervisors. To the extent possible, the RRB should rely on LRBs to provide the resources to conduct examinations of out-of-district subsidiaries of a parent organization, its state member bank subsidiaries, or the out-of-district offices of foreign banking organizations (FBOs). Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision.

In general, LRBs are responsible for the direct supervision of state member banks located in their district. In addition, the LRB provides the resources to the RRB to conduct the inspections of second-tier, domestic bank holding companies; nonbank subsidiaries; and branches and agencies of FBOs for top-tier holding companies located in the RRB's district. If the functional management of a banking organization is headquartered in its district, the LRB may also be called upon to conduct a functional business-line review. However, if a state member bank is owned by an out-of-district domestic holding company or if responsibility for supervision of the overall U.S. operations of the FBO lies with another Reserve Bank, the supervision of that entity should be coordinated by the RRB.

If the banking organization prefers to have supervisory contact with only one Reserve Bank, every effort should be made to centralize communication and coordination with the RRB for that organization. On the other hand, if the organization prefers more localized contact and communication, the coordination process can be adapted accordingly.

Central Point of Contact and Supervisory Teams

A central point of contact is critical to fulfilling the objectives of seamless, risk-focused supervision. The RRB should designate a central point of contact for each large, complex institu-

5. The State/Federal Supervisory Protocol and Agreement established definitions for home and host states. The home-state supervisor is defined as the state that issued the charter. It will act on behalf of itself and all host-state supervisors (states into which the bank branches) and will be the single state contact for a particular institution.

tion it supervises. Generally, all activities and duties of other areas within the Federal Reserve, as well as with other supervisors, should be coordinated through this contact. The central point of contact should—

- be knowledgeable, on an ongoing basis, about the institution's financial condition, management structure, strategic plan and direction, and overall operations;
- remain up-to-date on the condition of the assigned institution and be knowledgeable regarding all supervisory activities; monitoring and surveillance information; applications issues; capital-markets activities; meetings with management; and enforcement issues, if applicable;
- ensure that the objective of seamless, risk-focused supervision is achieved for each institution and that the supervisory products described later are prepared in a timely manner;
- ensure appropriate follow-up and tracking of supervisory concerns, corrective actions, or other matters which come to light through ongoing communications or surveillance; and
- participate in the examination process, as needed, to ensure consistency with the institution's supervisory plan and to ensure effective allocation of resources, including coordination of on-site efforts with specialty examination areas and other supervisors, as appropriate, and to facilitate requests for information from the institution, whenever possible.

A dedicated supervisory team composed of individuals with specialized skills based upon the organization's particular business lines and risk profile will be assigned to each institution. This full-time, dedicated cadre will be supplemented by other specialized System staff, as necessary, to participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an organization, the central point of contact is responsible for managing the supervisory team. The supervisory team's major responsibilities are to maintain a high level of knowledge of the banking organization and to ensure that supervisory strategies and priorities are consistent with the identified risks and institutional profile.

Sharing of Information

To further promote seamless, risk-focused supervision, information related to a specific institution should be provided, as appropriate, to other interested supervisors. The information to be shared includes the products described in the "Process and Products" subsection. However, sharing these products with the institution itself should be carefully evaluated on a case-by-case basis.

Functional Approach and Targeted Examinations

Traditionally, the examination process has been driven largely by a legal-entity approach to banking companies. The basis for risk-focused supervision of large, complex institutions relies more heavily on a functional, business-line approach to supervising institutions, while effectively integrating the functional approach into the legal-entity assessment.

The functional approach focuses principally on the key business activities (for example, lending, Treasury, retail banking) rather than on reviewing the legal entity and its balance sheet. This approach does not mean that the responsibility for a legal-entity assessment is ignored, nor should the Federal Reserve perform examinations of institutions that other regulators are primarily responsible for supervising.⁶ Rather, Federal Reserve examiners should integrate the findings of a functional review into the legal-entity assessment and coordinate closely with the primary regulator to gather sufficient information to form an assessment of the consolidated organization. Nonetheless, in some cases, effective supervision of the consolidated organization may require Federal Reserve examiners to perform process reviews and possibly transaction testing at all levels of the organization.

Functional risk-focused supervision is to be achieved by—

6. For U.S. banks owned by FBOs, it is particularly important to review the U.S. bank on a legal-entity basis and to review the risk exposure to the U.S. bank of its parent foreign bank since U.S. supervisory authorities do not supervise or regulate the parent bank.

- planning and conducting joint examinations with the primary regulator in areas of mutual interest, such as nondeposit investment products, interest-rate risk, liquidity, and mergers and acquisitions;
- leveraging off, or working from, the work performed by the primary regulator and the work performed by the institution’s internal and external auditors by reviewing and using their workpapers and conclusions to avoid duplication of effort and to lessen the burden on the institution;
- reviewing reports of examinations and other communications to the institution issued by other supervisors; and
- conducting a series of functional reviews or targeted examinations of business lines, relevant risk areas, or areas of significant supervisory concern during the supervisory cycle. Functional reviews and targeted examinations are increasingly necessary to evaluate the relevant risk exposure of a large, complex institution and the effectiveness of related risk-management systems.

The relevant findings of functional reviews or targeted examinations should be—

- incorporated into the annual summary supervisory report, with follow-up on deficiencies noted in the functional reviews or targeted examinations;
- conveyed to the institution’s management during a close-out or exit meeting with the relevant area’s line management; and
- communicated in a formal written report to the institution’s management or board of directors when significant weaknesses are detected or when the finding results in a downgrade of any rating component.

The functional approach to risk assessments and to planning supervisory activities should include a review of the parent company and its significant nonbank subsidiaries. However, the level of supervisory review should be appropriate to the risk profile of the parent company or its nonbank subsidiary in relation to the consolidated organization. Intercompany transactions should continue to be reviewed as part of the examination procedures performed to ensure that these transactions comply with laws and regulations and do not pose safety-and-soundness concerns.

Process and Products

The risk-focused methodology for the supervision program for large, complex institutions reflects a continuous and dynamic process. The methodology consists of six steps, each of which uses certain written products to facilitate communication and coordination.

Table 1—Steps and Products

<i>Steps</i>	<i>Products</i>
1. Understanding the institution	1. Institutional overview
2. Assessing the institution’s risk	2. Risk matrix 3. Risk assessment
3. Planning and scheduling supervisory activities	4. Supervisory plan 5. Examination program
4. Defining examination activities	6. Scope memorandum 7. Entry letter
5. Performing examination procedures	8. Functional examination modules
6. Reporting the findings	9. Examination report(s)

The focus of the products should be on fully achieving a risk-focused, seamless, and coordinated supervisory process, not simply on completing the products. The content and format of the products are flexible and should be adapted to correspond to the supervisory practices of the agencies involved and to the structure and complexity of the institution.

Understanding the Institution

The starting point for risk-focused supervision is developing an understanding of the institution. This step is critical to tailoring the supervision program to meet the characteristics of the organization and to adjusting that program on an ongoing basis as circumstances change. Furthermore, understanding the Federal Reserve’s

supervisory role in relation to an institution and its affiliates is essential.

Through increased emphasis on planning and monitoring, supervisory activities can focus on the significant risks to the institution and on related supervisory concerns. The technological and market developments within the financial sector and the speed with which an institution's financial condition and risk profile can change make it critical for supervisors to keep abreast of events and changes in risk exposure and strategy. Accordingly, the central point of contact for each large, complex institution should review certain information on an ongoing basis and prepare an institution overview that will communicate his or her understanding of that institution.

Information generated by the Federal Reserve, other supervisory agencies, the institution, and public organizations may assist the central point of contact in forming and maintaining an ongoing understanding of the institution's risk profile and current condition. In addition, the central point of contact should hold periodic discussions with the institution's management to cover, among other topics, credit-market conditions, new products, divestitures, mergers and acquisitions, and the results of any recently completed internal and external audits. When other agencies have supervisory responsibilities for the organization, joint discussions should be considered.

The principal risk-focused supervisory tools and documents, including an institutional overview, risk matrix, and risk assessment for the organization, should be current. Accordingly, the central point of contact should distill and incorporate significant new information into these documents at least quarterly. Factors such as emerging risks; new products; and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the organization's operations and risks, the more frequently the central point of contact should update the risk assessment, strategies, and plans.

Preparation of the Institutional Overview

The institutional overview should contain a concise executive summary that demonstrates an understanding of the institution's present condition and its current and prospective risk profiles, as well as highlights key issues and past

supervisory findings. General types of information that may be valuable to present in the overview include—

- a brief description of the organizational structure;
- a summary of the organization's business strategies as well as changes in key business lines, growth areas, new products, etc., since the prior review;
- key issues for the organization, either from external or internal factors;
- an overview of management;
- a brief analysis of the consolidated financial condition and trends;
- a description of the future prospects of the organization;
- descriptions of internal and external audit;
- a summary of supervisory activity performed since the last review; and
- considerations for conducting future examinations.

Assessing the Institution's Risks

To focus supervisory activities on the areas of greatest risk to an institution, the central point of contact should perform a risk assessment. The risk assessment highlights both the strengths and vulnerabilities of an institution and provides a foundation for determining the supervisory activities to be conducted. Further, the assessment should apply to the entire spectrum of risks facing an institution (as previously discussed in the subsection "Risk-Management Processes and Internal Controls").

An institution's business activities present various combinations and concentrations of the noted risks depending on the nature and scope of the particular activity. Therefore, when conducting the risk assessment, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities.

Assessment of the Overall Risk Environment

The starting point in the risk-assessment process is an evaluation of the institution's risk tolerance

and of management's perception of the organization's strengths and weaknesses. This evaluation should entail discussions with management and review of supporting documents, strategic plans, and policy statements. In general, management is expected to have a clear understanding of both the institution's markets and the general banking environment, as well as how these factors affect the institution.

The institution should have a clearly defined risk-management structure, which may be formal or informal, centralized or decentralized. However, the greater the risk assumed by the institution, the more sophisticated its risk-management system should be. Regardless of the approach, the types and levels of risk an institution is willing to accept should reflect its risk appetite, as determined by the board of directors.

To assess the overall risk environment, the central point of contact should make a preliminary evaluation of the institution's internal risk management, considering the adequacy of its internal audit, loan-review, and compliance functions. External audits also provide important information on the institution's risk profile and condition, which may be used in the risk assessment.

In addition, the central point of contact should review risk assessments developed by the internal audit department for significant lines of business, and compare those results with the supervisory risk assessment. Management's ability to aggregate risks on a global basis should also be evaluated. This preliminary evaluation can be used when developing the scope of examination activities to determine the level of examiner reliance on the institution's internal risk management.

Risk-monitoring activities must be supported by management information systems that provide senior managers and directors with timely and reliable reports on the financial condition, operating performance, and risk exposure of the consolidated organization. These systems must also provide managers engaged in the day-to-day management of the organization's activities with regular and sufficiently detailed reports for their areas of responsibility. Moreover, in most large, complex institutions, management information systems not only provide reporting systems, but also support a broad range of business decisions through sophisticated risk-management and decision-making tools such as credit-scoring and asset/liability models and automated

trading systems. Accordingly, the institution's risk assessment must consider the adequacy of its information technology systems.

Preparation of the Risk Matrix

A risk matrix is used to identify significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities, as well as to determine composite-risk assessments for each of these activities and the overall institution. A risk matrix can be developed for the consolidated organization, for a separate affiliate, or along functional business lines. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and is a basis for preparation of the narrative risk assessment.

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. After the significant activities are identified, the type and level of risk inherent in them should be determined. Types of risk may be categorized as previously described or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with that type of activity. The following definitions apply:

- *High inherent risk* exists when the activity is significant or positions are large in relation to the institution's resources or its peer group, when the number of transactions is substantial, or when the nature of the activity is inherently more complex than normal. Thus, the activity potentially could result in a significant and harmful loss to the organization.
- *Moderate inherent risk* exists when positions are average in relation to the institution's resources or its peer group, when the volume of transactions is average, and when the activity is more typical or traditional. Thus, while the activity potentially could result in a

loss to the organization, the loss could be absorbed by the organization in the normal course of business.

- *Low inherent risk* exists when the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote, or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

This risk-assessment is made without considering management processes and controls; those factors are considered when evaluating the adequacy of the institution's risk-management systems.

Assessing Adequacy of Risk Management

When assessing the adequacy of an institution's risk-management systems for identified functions or activities, the focus should be on findings related to the key elements of a sound risk-management system: active board and senior management oversight; adequate policies, procedures, and limits; adequate risk-management, monitoring, and management information systems; and comprehensive internal controls. (These elements are described in the earlier subsection "Elements of Risk Management.")

Taking these key elements into account, the contact should assess the relative strength of the risk-management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below:

- *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk-monitoring procedures, reports, and management information systems that provide the necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.

- *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk-management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.
- *Weak risk management* indicates risk-management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk-management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate.

To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided as follows:

- A *high composite risk* generally would be assigned to an activity in which the risk-

management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, in some cases, even when the systems are considered strong. For an activity with moderate inherent risk, a risk-management system that has significant weaknesses could result in a high-composite-risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.

- A *moderate composite risk* generally would be assigned to an activity with moderate inherent risk, which the risk-management systems appropriately mitigate. For an activity with low inherent risk, significant weaknesses in the risk-management system may result in a moderate-composite-risk assessment. On the other hand, a strong risk-management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
- A *low composite risk* generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk when internal controls and risk-management systems are strong, and when they effectively mitigate much of the risk.

Once the composite-risk assessment of each identified significant activity or function is completed, an overall composite-risk assessment should be made for off-site analytical and planning purposes. This assessment is the final step in the development of the risk matrix, and the evaluation of the overall composite risk is incorporated into the written risk assessment.

Preparation of the Risk Assessment

A written risk assessment is used as an internal supervisory planning tool and to facilitate communication with other supervisors. The goal is to develop a document that presents a comprehensive, risk-focused view of the institution, delineating the areas of supervisory concern and

serving as a platform for developing the supervisory plan.

The format and content of the written risk assessment are flexible and should be tailored to the individual institution. The risk assessment reflects the dynamics of the institution; therefore, it should consider the institution's evolving business strategies and be amended as significant changes in the risk profile occur. Input from other affected supervisors and specialty units should be included to ensure that all the institution's significant risks are identified. The risk assessment should—

- include an overall risk assessment of the organization;
- describe the types of risk (credit, market, liquidity, reputational, operational, legal) and their level (high, moderate, low) and direction (increasing, stable, decreasing);
- identify all major functions, business lines, activities, products, and legal entities from which significant risks emanate, as well as the key issues that could affect the risk profile;
- consider the relationship between the likelihood of an adverse event and its potential impact on an institution; and
- describe the institution's risk-management systems. Reviews and risk assessments performed by internal and external auditors should be discussed, as should the institution's ability to take on and manage risk prospectively.

The central point of contact should attempt to identify the cause of unfavorable trends, not just report the symptoms. The risk assessment should reflect a thorough analysis that leads to conclusions about the institution's risk profile, rather than just reiterating the facts.

Planning and Scheduling Supervisory Activities

The supervisory plan forms a bridge between the institution's risk assessment, which identifies significant risks and supervisory concerns, and the supervisory activities to be conducted. In developing the supervisory plan and examination schedule, the central point of contact should minimize disruption to the institution and, whenever possible, avoid duplicative examination efforts and requesting similar information from the other supervisors.

The institution's organizational structure and complexity are significant considerations when planning the specific supervisory activities to be conducted. Additionally, interstate banking and branching activities have implications for planning on-site and off-site review. The scope and location of on-site work for interstate banking operations will depend upon the significance and risk profile of local operations, the location of the supervised entity's major functions, and the degree of its centralization. The bulk of safety-and-soundness examinations for branches of an interstate bank would likely be conducted at the head office or regional offices, supplemented by periodic reviews of branch operations and internal controls. The supervisory plan should reflect the need to coordinate these reviews of branch operations with other supervisors.

Preparation of the Supervisory Plan

A comprehensive supervisory plan should be developed annually, and reviewed and revised at least quarterly to reflect any significant new information or emerging banking trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm their agreement on the overall plan for coordinating its implementation, when warranted.

The plan should demonstrate that supervisory concerns identified through the risk-assessment process and that the deficiencies noted in the previous examination are being or will be addressed. To the extent that the institution's risk-management systems are adequate, the level of supervisory activity may be adjusted. The plan should generally address all supervisory activities to be conducted, the scope of those activities (full or targeted), the objectives of those activities (for example, review of specific business lines, products, support functions, legal entities), and specific concerns regarding those activities, if any. Consideration should be given to—

- prioritizing supervisory resources on areas of higher risk;
- pooling examiner resources to reduce the regulatory burden on institutions as well as examination redundancies;
- maximizing the use of examiners who are located where the activity is being conducted;

- coordinating examinations of different disciplines;
- determining compliance with, or the potential for, supervisory action;
- balancing mandated requirements with the objectives of the plan;
- providing general logistical information (for example, a timetable of supervisory activities, the participants, and expected resource requirements); and
- assessing the extent to which internal and external audit, internal loan review, compliance, and other risk-management systems will be tested and relied upon.

Generally, the planning horizon to be covered is 18 months for domestic institutions.⁷ The overall supervisory objectives and basic framework need to be outlined by midyear to facilitate preliminary discussions with other supervisors and to coincide with planning for the Federal Reserve's annual scheduling conferences. The plan should be finalized by the end of the year, for execution in the following year.

Preparation of the Examination Program

The examination program should provide a comprehensive schedule of examination activities for the entire organization and aid in the coordination and communication of responsibilities for supervisory activities. An examination program provides a comprehensive listing of all examination activities to be conducted at an institution for the given planning horizon. To prepare a complete examination program and reflect the institution's current conditions and activities, and the activities of other supervisors, the central point of contact needs to be the focal point for communications on a particular institution. The role includes any communications with the Federal Reserve, the institution's management, and other supervisors. The examination program generally incorporates the following logistical elements:

- a schedule of activities, period, and resource estimates for planned projects

7. The examination plans and assessments of condition of U.S. operations that are used for FBO supervision use a 12-month period.

- an identification of the agencies conducting and participating in the supervisory activity (when there are joint supervisors, indicate the lead agency and the agency responsible for a particular activity) and resources committed by all participants to the area(s) under review
- the planned product for communicating findings (indicate whether it will be a formal report or supervisory memorandum)
- the need for special examiner skills and the extent of participation of individuals from specialty functions

Defining Examination Activities

Scope Memorandum

The scope memorandum is an integral product in the risk-focused methodology because it identifies the key objectives of the on-site examination. The focus of on-site examination activities, identified in the scope memorandum, follow a top-down approach that includes a review of the organization's internal risk-management systems and an appropriate level of transaction testing. The risk-focused methodology is flexible regarding the amount of on-site transaction testing used. Although the focus of the examination is on the institution's processes, an appropriate level of transaction testing and asset review will be necessary to verify the integrity of internal systems.

After the areas to be reviewed have been identified in the supervisory plan, a scope memorandum should be prepared that documents specific objectives for the projected examinations. This document is of key importance, as the scope of the examination will likely vary from year to year. Thus, it is necessary to identify the specific areas chosen for review and the extent of those reviews. The scope memorandum will help ensure that the supervisory plan for the institution is executed, and will communicate the specific examination objectives to the examination staff.

The scope memorandum should be tailored to the size, complexity, and current rating of the institution subject to review. For large but less complex institutions, the scope memorandum may be combined with the supervisory plan or the risk assessment. The scope memorandum should define the objectives of the examination, and generally should include—

- a statement of the objectives;
- an overview of the activities and risks to be evaluated;
- the level of reliance on internal risk-management systems and internal or external audit findings;
- a description of the procedures that are to be performed, indicating any sampling process to be used and the level of transaction testing, when appropriate;
- identification of the procedures that are expected to be performed off-site; and
- a description of how the findings of targeted reviews, if any, will be used on the current examination.

Entry Letter

The entry letter should be tailored to fit the specific character and profile of the institution to be examined and the scope of the activities to be performed. Thus, effective use of entry letters depends on the planning and scoping of a risk-focused examination. To eliminate duplication and minimize the regulatory burden on an institution, entry letters should not request information that is regularly provided to designated central points of contact or that is available within each Federal Reserve Bank. When needed for examinations of larger or more complex organizations, the entry letter should be supplemented by requests for information on specialty activities. The specific items selected for inclusion in the entry letter should meet the following guidelines:

- reflect risk-focused supervision objectives and the examination scope
- facilitate efficiency in the examination process and lessen the burden on financial institutions
- limit, to the extent possible, requests for special management reports
- eliminate items used for audit-type procedures (for example, verifications)
- distinguish between information to be mailed to the examiner-in-charge for off-site examination procedures and information to be held at the institution for on-site procedures
- allow management sufficient lead time to prepare the requested information

Examination Procedures

Examination procedures should be tailored to the characteristics of each institution, keeping in mind size, complexity, and risk profile. They should focus on developing appropriate documentation to adequately assess management's ability to identify, measure, monitor, and control risks. Procedures should be completed to the degree necessary to determine whether the institution's management understands and adequately controls the levels and types of risks that are assumed. For transaction testing, the volume of loans to be tested should be adjusted according to management's ability to accurately identify problems and potential problem credits, and to measure, monitor, and control the institution's exposure to overall credit risk. Likewise, the level of transaction testing for compliance with laws and regulations should take into account the effectiveness of management systems to monitor, evaluate, and ensure compliance with applicable laws and regulations.

During the supervisory cycle, the 10 functional areas listed below will be evaluated in most full-scope examinations. To evaluate these functional areas, procedures need to be tailored to fit the risk assessment that was prepared for the institution and the scope memorandum that was prepared for the examination. These functional areas represent the primary business activities and functions of large, complex institutions, as well as common sources of significant risk to them. Additionally, other areas of significant sources of risk to an institution or areas that are central to the examination assignment will need to be evaluated. The functional

areas include the following:

- loan portfolio analysis
- Treasury activities
- trading and capital-markets activities
- internal controls and audit
- supervisory ratings
- information systems
- fiduciary activities
- private banking
- retail banking activities
- payments system risk

Reporting the Findings

At least annually, a comprehensive summary supervisory report should be prepared that supports the organization's assigned ratings and encompasses the results of the entire supervisory cycle. This report should (1) convey the Federal Reserve's view of the condition of the organization and its key risk-management processes, (2) communicate the composite supervisory ratings, (3) discuss each of the major business risks, (4) summarize the supervisory activities conducted during the supervisory cycle and the resulting findings, and (5) assess the effectiveness of any corrective actions taken by the organization. This report will satisfy supervisory and legal requirements for a full-scope examination. Reserve Bank management, as well as Board officials, when warranted, will meet with the organization's board of directors to present and discuss the contents of the report and the Federal Reserve's assessment of the condition of the organization. (See SR-99-15.)

INTRODUCTION

This section sets forth the principal aspects of effective internal control and audit and discusses some pertinent points relative to the internal control questionnaires (ICQs). It assists the examiner in understanding and evaluating the objectives of and the work performed by internal and external auditors. It also sets forth the general criteria the examiner should consider to determine if the work of internal and external auditors can be relied on in the performance of the examination. To the extent that audit records can be relied on, they should be used to complete the ICQs implemented during the examination. In most cases, only those questions not fully supported by audit records would require the examiner to perform a detailed review of the area in question.

Effective internal control is a foundation for the safe and sound operation of a banking organization. The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control is effective. Their responsibility *cannot* be delegated to others within or outside the organization. An internal audit function is an important element of an effective system of internal control. When properly structured and conducted, internal audit provides directors and senior management with vital information about the condition of the system of internal control, and it identifies weaknesses so that management can take prompt, remedial action. Examiners are to review an institution's internal audit function and recommend improvements if needed. In addition, under the Interagency Guidelines Establishing Standards for Safety and Soundness,¹ pursuant to section 39 of the Federal Deposit Insurance Act (FDIA), each institution is required to have an internal audit function that is appropriate to its size and the nature and scope of its activities. The sound practices for the internal audit function and examiner guidance set forth in this section can be applied to bank holding companies and their subsidiaries and to U.S. operations of foreign banking organizations.

DIRECTOR AND SENIOR MANAGEMENT RESPONSIBILITIES

The board of directors and senior management are responsible for having an effective system of internal control—which includes an internal audit function—and for ensuring that the importance of internal control is understood and adhered to throughout the institution. This overall responsibility cannot be delegated to anyone else. The board and senior management may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management. The testing and assessment of internal controls may also be delegated to others. In discharging their responsibilities, directors and senior management should have reasonable assurance that the institution's system of internal control prevents or detects the following: inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial and regulatory reporting; and noncompliance with laws, regulations, and the institution's policies. (Specific responsibilities of the board of directors are discussed in the subsection "Directors' Strategy for Internal Control.")

OBJECTIVES OF INTERNAL CONTROL

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control:

Existence of procedures. Existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Con-

1. For state member banks, appendix D-1 to 12 CFR 208.

sequently, the examiner must give thoughtful attention not only to the prescribed set of procedures, but also to the practices actually followed. This attention can be accomplished through inquiry, observation, testing, or a combination thereof.

Competent performance. For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

Independent performance. If employees who have access to assets also have access to the related accounting records or perform related review operations (or immediately supervise the activities of other employees who maintain the records or perform the review operations), they may be able to both perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities.

In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which that individual would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly bank reconciliation. If the assistant appears to be a competent person, it may seem that an independent reconciliation would be performed and anything amiss would be reported. Such judgments are potentially erroneous. There exist no established tests by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it was performed by the supervisor. Hence, incompatible duties are present in that situation.

PROCEDURES FOR COMPLETING ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

To reach conclusions concerning a specific section of an ICQ, the examiner should document and review the bank's operating systems and procedures by consulting all available sources of information and discussing them with appropriate bank personnel. Sources of information might include organization charts, procedural manuals, operating instructions, job specifications, directives to employees, and other similar sources of information. Also, the examiner should not overlook potential sources such as job descriptions, flow charts, and other documentation contained in internal audit workpapers. A primary objective in the review of the system is to efficiently reach a conclusion about the overall adequacy of existing controls. Any existing source of information that will enable the examiner to quickly gain an understanding of the procedures in effect should be used in order to minimize the time required to formulate the conclusions. The review should be documented in an organized manner through the use of narrative descriptions, flow charts, or other diagrams. If a system is properly documented, the documentation will provide a ready reference for any examiner performing work in the area, and it often may be carried forward for future examinations, which will save time.

Although narrative descriptions can often provide an adequate explanation of systems of internal control, especially in less complex situations, they may have certain drawbacks, such as—

- they may be cumbersome and too lengthy,
- they may be unclear or poorly written,
- related points may be difficult to integrate, and

- annual changes may be awkward to record.

To overcome these problems, the examiner should consider using flow charts, which reduce narrative descriptions to a picture. Flow charts often reduce a complex situation to an easily understandable sequence of interrelated steps.

In obtaining and substantiating the answers to the questions contained in the ICQ, the examiner should develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to—

- become familiar with the ICQ;
- review related internal audit procedures, reports, and responses;
- review any written documentation of a bank's system of controls;
- find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals; and
- answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

An effective way to begin an on-site review of internal control is to identify the various key functions applicable to the area under review. For each position identified, the following questions should then be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or an irregularity is perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within an organization may be subject to control, not all have financial responsibilities that can influence the

accuracy of the accounting and financial records, or have access to assets. The examiner should be primarily concerned with those positions that have the ability to influence the records and that have access to assets. Once those positions have been identified, the examiners must exercise their professional knowledge of bank operations to visualize the possibilities open to any person holding a particular position. The question is not whether the individual is honest, but rather whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

The evaluation of internal control should include consideration of other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal part of the bank's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small banks, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by non-management personnel unlikely, even if disbursements are otherwise under the control of only one person.

When reviewing internal controls, an essential part of the examination is being alert to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert exists when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Also, offices staffed by members of the same family, branches completely dominated by a strong personality, or departments in which supervisors rely unduly on their assistants require special alertness on the part of the examiner. Those circumstances and other similar ones should be considered

in preparing the ICQ. It is not the formality of the particular factor that is of importance, but rather its effect on the overall operation under review. Circumstances that may affect answers to the basic questions should be noted along with conclusions concerning their effect on the examination.

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) test. However, certain questions are marked with an asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ.

The examiner should be alert for deviations by bank personnel from established policies, practices, and procedures. This applies not only to questions marked with an asterisk but also to every question in the ICQ. Examples of such deviations include situations when (1) instructions and directives are frequently not revised to reflect current practices; (2) employees find short-cuts for performing their tasks; (3) changes in organization and activities may influence operating procedures in unexpected ways; or (4) employees' duties may be rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures, thus giving the examiner an inadequate basis for evaluating internal control.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed here seem inapplicable. Care should be taken to resist drawing this conclusion. This discussion of internal control and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and records. Those with access may include computer operators, programmers, and their supervisors and other related personnel.

The final question in each section of the ICQ requires a composite evaluation of existing internal controls in the applicable area of the

bank. The examiner should base that evaluation on answers to the preceding questions within the section, the review and observation of the systems and controls within the bank, and discussion with appropriate bank personnel.

The composite evaluation does, however, require some degree of subjective judgment. The examiner should use all information available to formulate an overall evaluation, fully realizing that a high degree of professional judgment is required.

Applying the ICQ to Different Situations

The ICQs are general enough to apply to a wide range of systems, so not all sections or questions will apply to every situation, depending on factors such as bank size, complexity and type of operations, and organizational structure. When completing the ICQs, the examiner should include a brief comment stating the reason a section or question is not applicable to the specific situation.

For large banking institutions or when multiple locations of a bank are being examined, it may be necessary to design supplements to the ICQs to adequately review all phases of the bank's operations and related internal controls. Because certain functions described in this manual may be performed by several departments in some banks, it also may be necessary to redesign a particular section of the ICQ so that each department receives appropriate consideration. Conversely, functions described in several different sections of this handbook may be performed in a single department in smaller banks. If the ICQ is adapted to fit a specific situation, care should be taken to ensure that its scope and intent are not modified. That requires professional judgment in interpreting and expanding the generalized material. Any such modifications should be completely documented and filed in the workpapers.

LEGAL REQUIREMENTS AFFECTING BANKS AND THE AUDIT FUNCTION

On May 11, 1993, the board of directors of the Federal Deposit Insurance Corporation (FDIC)

approved the regulations and guidelines implementing audit requirements of section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). Since that date, the FDIC has adopted amendments to these regulations and guidelines primarily in response to changes made to the original statute. These regulations and guidelines require institutions that must comply with FDICIA section 112 to file with the FDIC and the primary regulator (1) audited financial statements, (2) a report on the effectiveness of internal controls over financial reporting, and (3) a report on compliance with designated laws and regulations. Institutions subject to FDICIA section 112 are referred to as covered institutions and include domestic insured depository institutions as well as foreign branches and agencies. A covered institution must have an audit committee made up solely of independent outside directors and may also be required to satisfy other audit committee membership criteria.

Effective for fiscal years beginning after December 31, 1992, covered institutions with total assets of \$500 million or more must comply with the provisions of section 112 of FDICIA. Among other things, this section requires—

- a covered institution to assess the effectiveness of its internal control structure over financial reporting, and to file a report with both the FDIC and the institution's primary bank regulator;
- independent public accountants to attest to the accuracy of management's assertions on the internal control structure over financial reporting;
- a covered institution to assess its compliance with designated safety-and-soundness laws and regulations, and to provide a report to both the FDIC and the institution's primary bank regulator;
- independent public accountants to perform agreed-upon procedures to objectively determine the accuracy of management's assertions on compliance with safety-and-soundness laws and regulations; and
- each covered institution to have an audit committee composed solely of outside directors. The audit committees of large institutions must have at least two members with banking or related financial management expertise who have access to outside legal counsel, and committees shall not include

individuals who are large customers of the institution.

With regard to the first three bullets (requirements) and effective April 1, 1996, any covered institutions with a composite CAMELS rating of 1 or 2 may file the reports discussed above through their parent holding company on a consolidated basis. Section 36 of the Federal Deposit Insurance Act (FDIA), as amended by FDICIA, requires all institutions with total assets of more than \$500 million to have an independent audit committee. One of the duties of the audit committee, as required by the implementing regulation, includes the oversight of the internal audit function and its operations.

ENSURING THE FUNCTIONING OF THE INTERNAL CONTROL SYSTEM

Some institutions have chosen to rely on “management self-assessments” or “control self-assessments” for evaluating the effectiveness of internal control, wherein business-line managers and their staff evaluate the performance of internal controls within their business lines. Although such reviews help to underscore management's responsibility for internal control, they are not impartial. Directors and senior managers who rely too much on self-assessment reviews may not learn of control weaknesses until they have become costly problems—particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should have their internal controls tested and assessed by units without business-line responsibilities, such as an internal audit group.

Directors' Strategy for Internal Control

Directors should be confident that the internal audit function meets the demands posed by the institution's current and planned activities. Directors and senior managers should ensure that their internal audit function reflects the components described below.

Structure

The internal audit function should be positioned within the management hierarchy so that directors have confidence that internal audit staff will perform their duties with impartiality and not be unduly influenced by managers with day-to-day responsibility for line operations. In the typical institution, the internal audit manager reports directly to the board of directors or its audit committee.² Other institutions have consolidated several audit functions, such as loan review, market-risk management, and loan compliance, with an internal audit function that is under a single manager who reports to the full board or committee of directors.

The internal audit manager should not have responsibilities that could jeopardize his or her impartiality for assessing the performance of other functions or lines of business. Thus, the internal audit manager typically is not responsible for earning profits or generating revenue for the organization. However, arrangements that would not create a conflict in performing the internal audit function are allowable. Likewise, managing audit functions that focus on risks other than the system of internal controls would not generally bias the attitude of the internal audit manager. However, it may be prudent for an institution to periodically audit the performance of its internal audit function and the other areas under the control of the audit function's manager. Organizations that do so typically engage an external party, such as a certified public accounting firm, to carry out the performance audit. The results of these performance audits should be reported to the board of directors and senior management.

Communication

To properly discharge their responsibility for internal control, directors should encourage candor and critical examination of issues between internal audit staff and management. This openness will increase the directors' knowledge and ability to assess both the internal auditor's

findings and management's solutions to known internal control weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors, its audit committee, or senior management. In periodic meetings with management and the internal audit manager, the audit committee should assess whether management is resolving internal control weaknesses or other exceptions diligently. Moreover, the audit committee should give the internal audit manager the opportunity to privately discuss his or her findings (that is, without management's presence).

In the typical institution, a system has been established for reporting audit results and monitoring resolution of identified deficiencies. Critical to the functioning of this reporting system is the internal audit manager's unrestricted access to the board of directors or its audit committee and to senior management. Furthermore, line management should not be able to influence the internal audit manager into making significant changes in audit scope or deleting issues from audit reports without the concurrence of the board of directors.

Internal Audit Management, Staffing, and Quality

The directors should assign responsibility for the internal audit function to a manager who has sufficient expertise in banking and auditing to understand the institution's activities and the threats these activities pose to the objectives of internal control. The audit function manager should be able to judge the effectiveness of the internal control system. The board or its audit committee should have objective performance criteria to evaluate the performance of the internal audit function and its manager.³

Audit resources should be sufficient to perform a series of audits that are appropriate to the institution's size and complexity. The adequacy of audit resources can be determined by evaluating whether a credible and robust audit plan was completed in a timely manner. If the internal audit function's performance is at variance

2. Institutions subject to section 36 of FDIA must maintain independent audit committees (that is, committees composed of directors who are not members of management). For institutions not subject to an audit committee requirement, the board of directors can fulfill the audit committee responsibilities discussed in this policy statement.

3. For example, the performance criteria could include the timeliness of each completed audit, comparison of overall performance to plan, and other measures.

with the audit plan, the board of directors or its audit committee should determine the reasons for the variance and decide what corrective actions are appropriate. If audit resources are insufficient, the deficiencies should be remedied. Typical actions may include replacing the manager of the internal audit function, increasing staff and training, acting to reduce turnover, or outsourcing specific audits to outside experts.

Staff in the internal audit function and their work should adhere to reasonable professional standards. Some institutions may adapt the standards for external auditors of the American Institute of Certified Public Accountants (AICPA) for use in their internal audit work. Other institutions may follow the Institute for Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. Whatever standards an organization chooses to follow, they should address the independence, professional proficiency, scope of work, performance of audit work, and management of internal audit.

Scope

The board of directors or audit committee should ensure that the internal audit function has free range of the institution or should approve any restrictions imposed by senior management. Furthermore, the board should assure itself that the work program proposed by the internal audit manager is consistent with the nature, complexity, and risk of the institution's activities. The board or audit committee should concur with the internal audit manager's control-risk assessment and the audit plan (described below), as well as monitor his or her performance relative to the audit plan. The board or audit committee should consider requests for expansion of audit scope when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.⁴

4. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These include (1) new management; (2) areas or activities experiencing rapid growth; (3) new lines of business, products or technologies; (4) corporate restructurings, mergers, and acquisitions; and (5) expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

Independence of Internal Auditors

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditing can be determined by its reporting lines within the organization and by the person or level to whom these results are reported. In most circumstances, the internal audit function is under the direction of the board of directors or a committee thereof, such as the audit committee. This relationship enables the internal audit function to assist the directors in fulfilling their responsibilities.

The auditor's responsibilities should be addressed in a position description, with reporting lines delineated in personnel policy, and audit results should be documented in audit committee and board of directors' minutes. Examiners should review these documents, as well as the reporting process followed by the auditor, in order to subsequently evaluate the tasks performed by the internal audit function. The internal auditor should be given the authority necessary to perform the job, including free access to any records necessary for the proper conduct of the audit. Furthermore, internal auditors generally should not have responsibility for the accounting system, other aspects of the institution's accounting function, or any operational function not subject to independent review.

Competence of Internal Auditors

The responsibilities and qualifications of internal auditors vary depending on the size and complexity of a bank's operations and on the emphasis placed on the internal audit function by the directorate and management. In many banks, the internal audit function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other banks, particularly small ones, internal audit may be performed on a part-time basis by an officer or employee.

The qualifications discussed below should not be viewed as minimum requirements, but should be considered by the examiner in evaluating the work performed by the internal auditors or audit departments. Examples of the type of qualifications an internal audit department manager should have are—

- academic credentials comparable to other bank officers who have major responsibilities within the organization,
- commitment to a program of continuing education and professional development,
- audit experience and organizational and technical skills commensurate with the responsibilities assigned, and
- oral and written communication skills.

The internal audit department manager must be properly trained to fully understand the flow of data and the underlying operating procedures. Training may come from college courses, courses sponsored by industry groups such as the Bank Administration Institute (BAI), or in-house training programs. Significant work experience in various departments of a bank also may provide adequate training. Certification as a chartered bank auditor, certified internal auditor, or certified public accountant meets educational and other professional requirements. In addition to prior education, the internal auditor should be committed to a program of continuing education, which may include attending technical meetings and seminars and reviewing current literature on auditing and banking.

The internal auditor's organizational skills should be reflected in the effectiveness of the bank's audit program. Technical skills may be demonstrated through internal audit techniques, such as internal control and other questionnaires, and an understanding of the operational and financial aspects of the organization.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the bank for filling the positions in the internal audit department and the training available for that position. In addition, the examiner must be assured that any internal audit supervisor understands the audit objectives and procedures performed by the staff.

In a small bank, it is not uncommon to find that internal audit, whether full- or part-time, is a one-person department. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager, as previously discussed.

The final measure of the competence of the internal auditor is the quality of the work performed, the ability to communicate the results of that work, and the ability to follow up on deficiencies noted during the audit work. Accordingly, the examiner's conclusions with respect to an auditor's competence should also reflect the adequacy of the audit program and the audit reports.

IMPLEMENTATION OF THE INTERNAL AUDIT FUNCTION

The annual audit plan and budgets should be set by the internal audit manager and approved by the board, audit committee, or senior management. In many organizations, the internal audit manager reports to a senior manager for administrative purposes. The senior manager appraises the audit manager's performance, and the directors or audit committee approves the evaluation.

Risk Assessment

In setting the annual audit plan, a risk assessment should be made that documents the internal audit function's understanding of the institution's various business activities and their inherent risks. In addition, the assessment also evaluates control risk, or the potential that deficiencies in the system of internal control would expose the institution to potential loss. The assessment should be periodically updated to reflect changes in the system of internal control, work processes, business activities, or the business environment. The risk-assessment methodology of the internal audit function should identify all auditable areas, give a detailed basis for the auditors' determination of relative risks, and be consistent from one audit area to another. The risk assessment can quantify certain risks, such as credit risk, market risk, and legal risk. It can also include qualitative aspects, such as the timeliness of the last audit and the quality of management. Although there is no standard approach to making a risk assessment, it should be appropriate to the size and complexity of the institution. While smaller institutions may not have elaborate risk-assessment systems, some analysis should still be available to explain why

certain areas are more frequently audited than others.

Within the risk assessment, institutions should clearly identify auditable units along business activities or product lines, depending on how the institution is managed. There should be evidence that the internal audit manager is regularly notified of new products, departmental changes, and new general ledger accounts, all of which should be factored into the audit schedule. Ratings of particular business activities or corporate functions may change with time as the internal audit function revises its method for assessing risk. These changes should be incremental. Large-scale changes in the priority of audits should trigger an investigation into the reasonableness of changes to the risk-assessment methodology.

Audit Plan

The audit plan is based on the risk assessment. It should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.

A formal, annual audit plan should be developed based on internal audit's risk assessment. The audit plan should include all auditable areas and set priorities based on the rating determined by the risk assessment. The schedule of planned audits should be approved by the board or its audit committee, as should any subsequent changes to the plan. Many organizations develop an audit plan jointly with the external auditors. In this case, the audit plan should clearly indicate what work is being performed by internal and external auditors, and what aspects of internal audit work the external auditors are relying on.

Typically, the schedule of audit is cyclic, for example, high risks are audited annually, moderate risks every two years, and low risks every three years. In some cases, the audit cycle may extend beyond three years. In reviewing the annual plan, examiners should determine the appropriateness of the institution's audit cycle. Some institutions limit audit coverage of their low-risk areas. Examiners should review areas the institution has labeled "low risk" to determine if the classification is appropriate and if coverage is adequate.

Audit Manual

The internal audit department should have an audit manual that sets forth the standards of work for field auditors and audit managers to use in their assignments. A typical audit manual contains the audit unit's charter and mission, administrative procedures, workpaper-documentation standards, reporting standards, and review procedures. Individual audits should conform to the requirements of the audit manual. As a consequence, the manual should be up to date with respect to the audit function's mission and changes to the professional standards it follows.

Performance of Individual Audits

The internal audit manager should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide them. The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and to assess whether internal controls are effective. While audits vary according to the objective, the area subjected to audit, the standards used as the basis for work performed, and documentation, the audit process generates some common documentation elements, as described below.

Audit Program and Related Workpapers

The audit program documents the audit's objectives and the procedures that were performed. Typically, it indicates who performed the work and who has reviewed it. Workpapers document the evidence gathered and conclusions drawn by the auditor, as well as the disposition of audit findings. The workpapers should provide evidence that the audit program adheres to the requirements specified in the audit manual.

Audit Reports

The audit report is internal audit's formal notice of its assessment of internal controls in the audited areas. The report is given to the area's managers, senior management, and directors. A

typical audit report states the purpose of the audit and its scope, conclusions, and recommendations. Reports are usually prepared for each audit. In larger institutions, monthly or quarterly summaries that highlight major audit issues are prepared for senior management and the board.

Small Financial Institutions

An effective system of internal control, including an independent internal audit function, is a foundation for safe and sound operations, regardless of an institution's size. The procedures assigned to the internal audit function should include adequate testing and review of internal controls and information systems. Management is responsible for carefully considering the level of auditing that will effectively monitor their institution's internal control system, taking into account the audit function's costs and benefits.

Small institutions often use alternatives to a group of employees solely dedicated to performing the internal audit function. For example, a small institution can gain some assurance about the effectiveness of its internal controls by having employees from outside the business unit being audited review that unit's key internal controls. These employees should have sufficient knowledge and competency to judge the effectiveness of internal controls and should not be directly involved in the day-to-day management of the business area. The employees conducting the review should also be able to report their findings directly to senior management or the board.

EXAMINER REVIEW OF INTERNAL AUDIT

The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor. The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and effectiveness of the audit program should be determined separately for each examination area.

The examiner should assess if the work performed by the internal auditor is reliable. It is often more efficient for the examiner to determine the independence and/or competence of the internal auditor before addressing the adequacy and/or effectiveness of the audit program. If the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the examiner must also conclude that the internal audit work performed is not reliable. Accordingly, a review of such work may not be necessary.

The Federal Reserve recognizes that the frequency of internal audit procedures should be based on an evaluation of risk associated with each area of interest. There may be situations in which the associated risk is considered minimal due to the materiality of the amounts involved, the internal control procedures followed, the bank's history in a particular area, or other factors. For example, in many large banks with extensive branch systems, internal audits of cash on hand at the branches may be scheduled on a rotating basis once every one or two years. A rotating cash-count program is frequently combined with periodic surprise cash counts by branch officers. In this and similar situations, the examiner may conclude that sufficient evidence exists to accept the frequency followed by the internal auditor.

The examiner should indicate in the report of examination any significant deficiencies concerning the internal audit function. Furthermore, the examiner should review with management any significant deficiencies noted in the previous report of examination to determine if these concerns have been appropriately addressed.

Program Adequacy and Effectiveness

An examiner should consider the following factors when assessing the adequacy of the internal audit program—

- scope and frequency of the work performed,
- content of the programs,
- documentation of the work performed, and
- conclusions reached and reports issued.

The scope of the internal audit program must be sufficient to attain the audit objectives. The frequency of the audit procedures performed should be based on an evaluation of the risk

associated with each targeted area under audit. Among the factors that the internal auditor should consider in assessing risk are the nature of the operation of the specific assets and liabilities under review, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

To further assess the adequacy and effectiveness of the internal audit program, an examiner needs to obtain audit workpapers. Workpapers should contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of the testing, and the basis for the conclusions reached.

Although audit work programs are an integral part of the workpapers, they are sufficiently important to deserve separate attention. Work programs serve as the primary guide to the audit procedures to be performed. Each program should provide a clear, concise description of the work required, and individual procedures should be presented logically. The detailed procedures included in the program vary depending on the size and complexity of the bank's operations and the area subject to audit. In addition, an individual audit work program may encompass several departments of the bank, a single department, or specific operations within a department. Most audit programs include procedures such as—

- surprise examinations, where appropriate;
- maintenance of control over records selected for audit;
- review and evaluation of the bank's policies and procedures and the system of internal control;
- reconciliation of detail to related control records; and
- verification of selected transactions and balances through procedures such as examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives. Audit conclusions should be supported by report findings; such reports should include, when appropriate, recommendations by the internal auditor for any

required remedial actions.

The examiner should also analyze the internal reporting process for the internal auditors' findings, since required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. This means that the auditor must communicate all findings and recommendations clearly and concisely, pinpointing problems and suggesting solutions. The auditor also should submit reports as soon as practical, and the reports should be routed to those authorized to implement the suggested changes.

The final measure of the effectiveness of the audit program is a prompt and effective management response to the auditor's recommendations. The audit department should determine the reasonableness, timeliness, and completeness of management's response to their recommendations, including follow-up, if necessary. Examiners should assess management's response and follow up in those instances where it is either incomplete or unreasonable.

EXTERNAL AUDITS

The Federal Reserve requires bank holding companies with total consolidated assets of \$500 million or more to have annual independent audits. Generally, banks must have external audits for the first three years after obtaining FDIC insur-

ance (an FDIC requirement) and upon becoming a newly chartered national bank (an OCC requirement). The Securities and Exchange Commission (SEC) also has a longstanding audit requirement for all public companies, which applies to bank holding companies that are SEC registrants and to state member banks that are subject to SEC reporting requirements pursuant to the Federal Reserve's Regulation H.

For insured depository institutions with fiscal years beginning after December 31, 1992, FDICIA, through its amendments to the FDIC Act, requires annual independent audits for all FDIC-insured banks that have total assets in excess of \$500 million.

Independent audits enhance the probability that financial statements and reports to the FRB and other financial statement users will be accurate, and help detect conditions that could adversely affect banking organizations, the FRB, or the public. The independent audit process also subjects the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review.

The bylaws of many banks require certain audit procedures, as determined by state law or the board of directors, be performed periodically. Such procedures are often referred to as directors' examinations. External auditors frequently assist with directors' examinations and in many cases, these auditors are CPAs. Occasionally, however, the work may be performed by individuals who are not CPAs, but who are familiar with audit requirements. In other instances, the directors may consider the internal audit program sufficient to satisfy the requirement. The directors should participate in the directors' examinations, at least to the extent of appraising the bank's policies and the procedures used to attain policy objectives, including the review of the FRB report of examination with the auditors.

Banks often employ external auditors and other specialists to assist management in specialized fields, such as taxation and management information systems. External auditors and consultants often conduct in-depth reviews of the operations of specific bank departments; the reviews might focus on operational procedures, personnel requirements, or other specific areas of interest. After completing the reviews, the auditors may recommend that the bank strengthen controls and/or improve efficiency.

External auditors provide services at various times during the year. Financial statements are

examined annually. Generally, the process commences in the latter part of the year, with the report issued as soon thereafter as possible. Other types of examinations or reviews are performed at various dates on an as-required basis.

The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise where internal audit work is not being performed, or where such work is deemed to be of limited value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, external audit reports often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

Certified Public Accountants

This section discusses the standards for competence and independence of certified public accountants (CPAs), as well as the standards required in connection with their audits.

Standards of Conduct

The Code of Professional Ethics for CPAs who are members of the American Institute of Certified Public Accountants (AICPA) requires that audits be performed according to generally accepted auditing standards (GAAS). GAAS, as distinct from generally accepted accounting principles, or GAAP, are concerned with the auditor's professional qualifications, the judgment the auditor exercises in the performance of an audit, and the quality of the audit procedures.

On the other hand, GAAP represents all of the conventions, rules, and procedures that are necessary to define accepted accounting practices at a particular time. GAAP includes broad guidelines of general application and detailed practices and procedures that have been issued by the Financial Accounting Standards Board (FASB), the AICPA, the SEC, or other authoritative bodies that set accounting standards. Thus,

GAAP provides guidance on financial reporting matters.

Generally Accepted Auditing Standards

GAAS is grouped into three categories: general standards, standards of field work, and standards of reporting.

The general standards require that the audit be performed by a person or persons having adequate technical training and proficiency; that independence in mental attitude be maintained; and that due professional care be exercised in the performance of the audit and the preparation of the report.

Standards of field work require that the work be adequately planned; assistants, if any, be properly supervised; a proper study and evaluation of existing internal controls be made for determining the audit scope and the audit procedures to be performed during the audit; and sufficient evidence be obtained to formulate an opinion regarding the financial statements under audit.

Standards of reporting require that the CPA state whether the financial statements are presented in accordance with GAAP. The application of GAAP in audited financial statements and reports must achieve the fundamental objectives of financial accounting, which is to provide reliable financial information about the economic resources and obligations of a business enterprise. In addition, the informative disclosures in the financial statements must follow GAAP, or the CPA must state otherwise in the report.

GAAS recognizes that management—not the CPA—has primary responsibility for the preparation of the financial statements and the presentations therein. The auditor's responsibility is to express an opinion on the financial statements. GAAS (or the audit requirements previously set forth) requires that audits cover the following financial statements: balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows.

GAAS requires that CPAs plan and perform auditing procedures to obtain reasonable assurance that financial statements are free from material misstatement. Under GAAS, an audit includes examining on a test basis, and should

include evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Independence

In the performance of their work, CPAs must be independent of those they serve. Traditionally, independence has been defined as the ability to act with integrity and objectivity. In accordance with the rule on independence included in the Code of Professional Ethics and related AICPA interpretations, the independence of a CPA is considered to be impaired if, during the period of his or her professional engagement, the CPA or his or her firm had any direct or material indirect financial interest in the enterprise, or had any loan to or from the enterprise or any officer, director, or principal stockholder thereof. The latter prohibition does not apply to the following loans from a financial institution when made under normal lending procedures, terms, and requirements:

- automobile loans and leases collateralized by the automobile;
- loans in the amount of the cash surrender value of a life insurance policy;
- borrowings fully collateralized by cash deposits at the same financial institution (for example, passbook loans); and
- credit cards and cash advances under lines of credit associated with checking accounts with aggregate unpaid balances of \$5,000 or less.

Such loans must, at all times, be kept current by the CPA as to all terms.

Other loans have been grandfathered by the AICPA under recent ethics interpretations. These other loans (mortgage loans, other secured loans, and loans not material to the AICPA member's net worth) must, at all times, be current as to all terms and shall not be renegotiated with the client financial institution after the latest of—

- January 1, 1992;
- the date that the financial institution first becomes a client;
- the date the loans are sold from a nonclient

financial institution to the client financial institution; or

- the date of becoming a member in the AICPA.

The examiner may decide under certain circumstances to test the independence of the CPA through reviews of loan listings, contracts, stockholder listings, and other appropriate measures. Concerns about independence should be identified in the report of examination.

External Audit Reports

The external auditor generates various types of reports and other documents. These reports typically include:

- The standard audit report, which is generally a one-page document.
- A “management letter” in which the auditor confidentially presents detailed findings and recommendations to management.
- In some cases, reports from the auditor to regulators during the audit period.

The major types of standard audit reports will never have a heading or other statement in the report that identifies which type it is. Rather, the type of report is identified by certain terminology used in the text of the report. The major types of standard audit reports are:

The unqualified report—sometimes referred to as a “clean opinion.” This type states that the financial statements are “presented fairly” in conformity with GAAP, and that the necessary audit work was done.

The qualified report—which may generally have the same language as the unqualified report but will use the phrase “except for” or some other qualification to indicate that some problem exists. The type of problems includes a lack of sufficient evidential matter, restrictions on the scope of audit work, or departures from GAAP in the financial statements. This type of report is not necessarily negative, but indicates that the examiner should ask additional questions of management.

An adverse report—which basically concludes that the financial statements are not presented fairly in conformity with GAAP. This type of

report is rarely issued because auditors and management usually work out their differences in advance.

A disclaimer—which expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt exists about the ability of the institution to continue as a going concern for a reasonable period of time. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.

External Audit Review

The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the CPA.

The Federal Reserve has concluded that in view of its objectives regarding the reliance placed on the work performed by CPAs, the examiner should conduct an in-depth review of the competence and independence of the CPA only in unusual situations because of the professional and ethical standards of the public accounting profession. One such situation would be a recent change in CPAs by a bank, particularly if the change was made after an audit was commenced.

Ordinarily, it is not necessary to make specific tests to determine independence. However, there may be occasions when the examiner has sufficient reason to question the independence of a CPA or the quality of his or her work. For example, the examiner may discover that during the period of a CPA’s professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- had a direct financial interest in the bank;
- was connected with the bank in a capacity equivalent to that of a member of management or was a director of the bank;
- maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records; or
- had a prohibited loan from the bank (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's examination by reviewing the most recent report issued by the CPA. If the audit is in progress or is planned to commence in the near future, the examiner should review any engagement letter to the bank from the CPA. The examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion, or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations, a review of this work performed by the CPA may help the examiner understand the problem that gave rise to this opinion.

Limitations of Audits and Audited Financial Statements

Although auditing standards are designed to require the use of due care and objectivity, a properly designed and executed audit does not necessarily guarantee that all misstatements of amounts or omissions of disclosure in the financial statements have been detected. Moreover, a properly designed and executed audit does not guarantee that the auditor addressed FRB safety and soundness considerations. Examination personnel should be cognizant of the limitations inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the transactions and balances are reported in accordance with GAAP. It does not mean that the transactions made business sense, that the associated risks are managed in a safe and sound manner, or that the balances can be recovered upon disposition or liquidation.
- The auditor's report concerning financial statements does not signify that underwriting standards, operating strategies, loan monitoring

systems, and workout procedures are adequate to mitigate losses if the environment changes. The auditor's report that financial statements present fairly the bank's financial position is based upon the prevailing evidence and current environment, and indicates that reported assets can be recovered in the normal course of business. In determining that reported assets can be recovered in the normal course of business, the auditor attempts to understand financial reporting internal controls and can substitute other audit procedures when these controls are weak or nonexistent.

- The quality of management and how it manages risk are not considered in determining historical cost and its recoverability. Although certain assets and instruments are marked-to-market (for example, trading accounts), GAAP generally uses historical cost as the basis of presentation. Historical cost assumes that the entity is a going concern. The going concern concept allows certain mark-to-market losses to be deferred because management believes the cost basis can be recovered during the remaining life of the asset.
- GAAP financial statements offer only limited disclosures of risks, uncertainties, and the other safety and soundness factors on which the institution's viability depends.
- For purposes of determining the level of loan loss reserves, GAAP does not consider losses that are "more likely than not," "reasonably possible," or "likely" to occur in future periods. Under GAAP, loan loss reserves are provided for "probable losses" and for losses currently "inherent" (that is, anticipated future charge-offs based on current repayment characteristics) in the portfolio.

Communication with External Auditors

GAAS requires that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, the external auditor may review communications from, and make inquiries of, the regulatory authorities.

Generally, the Federal Reserve encourages auditors to attend examination exit conferences upon completion of the examiner's field work or other meetings concerning examination findings

between supervisory examiners and an institution's management or board of directors (or a committee thereof). Banks should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the institution should first obtain the approval of the appropriate Federal Reserve Bank personnel for the auditor to attend the meetings. The Interagency Policy Statement of July 23, 1992, does not preclude the Federal Reserve from holding meetings with the management of banks without auditor attendance or from requiring that the auditor attend only certain portions of the meetings.

The Interagency Policy Statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide banking organizations with advance notice of the starting date of the examination when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

Some institutions prefer that audit work be completed at different times than examination work to reduce demands upon their staff members and facilities. Other institutions prefer to have audit work and examination work performed during similar periods so the institution's operations are affected only at certain times during the year. By knowing when examinations are planned, institutions have the flexibility to schedule external audit work concurrent with, or separate from, examinations.

Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with the FRB regulatory authorities involved in the supervision of the institution or its holding company during or after completion of examinations to inquire about supervisory matters relevant to the institution under audit. External auditors should provide an agenda in advance. The FRB regulatory authorities will generally

request that management of the institution under audit be represented at the meeting. In this regard, examiners generally will only discuss with an auditor examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the institution without bank management representation. External auditors may request such confidential meetings with the FRB regulatory authorities, who may also request such meetings with the external auditor.

Information Required to Be Made Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and section 112 of FDICIA pertain to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. FIRREA and FDICIA require banks to provide the auditor with copies of the most recent Report of Condition (call report) and report of examination, and pertinent correspondence or reports received from its regulator. This information is to be provided to the external auditor by the bank under audit, not by the FRB.

In addition, banking organizations must provide the independent auditor with:

- A copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the bank put into effect during the period covered by the audit.
- A report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the bank or any banking organization affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 931 of FIRREA (12 USC 1817(a)) and report instances of noncompliance in the report of examination.

Confidentiality of Supervisory Information

While the policies of the FRB regulatory authorities permit external auditors to have access to

the information described above, institutions and their auditors are reminded that information contained in examination reports, inspection reports, and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the FRB. Unauthorized disclosure of confidential supervisory information may lead to civil and criminal actions and fines and other penalties.

AUDIT COMMITTEE OVERSIGHT

Internal and external auditors will not, in all likelihood, feel free to assess the bank's operations if their independence is compromised. This can sometimes happen when internal and external auditors report solely to senior management instead of to the board of directors.

The independence of internal and external auditors is increased when they report to an independent audit committee (one made up of external directors who are not members of the bank's management). The auditors' independence is enhanced when the audit committee takes an active role in approving the internal and external audit scope and plan.

The role of the independent audit committee is growing in importance. The audit committee's duties may include overseeing the internal audit function, such as approving salary, hiring, and firing decisions relating to senior staff level positions; approving or recommending the appointment of external auditors and the scope of external audits and other services; providing the opportunity for auditors to meet and discuss findings apart from management; reviewing with management and external auditors the year-end financial statements; and meeting with regulatory authorities.

Internal Control

Examination Objectives

Effective date May 1993

Section 1010.2

1. To determine whether internal and external audit functions exist.
2. To evaluate the independence of those who provide the internal and external audit functions.
3. To evaluate the competence of those who provide the internal and external audit functions.
4. To determine adequacy of the procedures performed by the internal and external auditors.
5. To determine, based upon the criteria above, if the work performed by internal and external auditors is reliable.

Internal Control

Examination Procedures

Effective date May 1993

Section 1010.3

This examination program must be used in conjunction with the audit function questionnaire section to review the bank's internal and external audits and the audit procedures they encompass. The audit guidelines are general and all sections or questions will not be applicable to every bank.

Prior to reviewing any specific audit procedures, the examiner should first determine the independence and competence of the auditors. If the examiner believes the auditors to be both competent and independent, he or she should then determine the acceptability of their work. Based on the answers to the audit function questions and on the auditor's work, the examiner must then determine the scope of the examination.

The program and related supporting documentation should be completed in an organized manner and should be retained as part of the examination workpapers.

Upon completion of the program, the examiner should be able to formulate a conclusion on the adequacy of audit coverage. Conclusions of weaknesses in the internal audit work being performed at the bank should be summarized for inclusion in the report of examination. Significant recommendations should be discussed with bank management and noted in the questionnaire and in the report of examination. If recommendations are made orally, a memorandum of the discussion should be prepared and included in the workpapers.

INTERNAL AUDITORS

1. *Organizational Structure of the Audit Department*

Review the bylaws and the organization chart of the bank and the minutes of the board's audit/examining committee to determine how effectively the board of directors is discharging its responsibility.

2. *Independence of the Audit Function*

Interview the auditor and observe the operation of the audit department to determine its functional responsibilities.

3. *Auditors' Qualifications*

Review biographical data and interview

the auditor to determine his or her ability to manage the auditor's responsibility in the bank.

4. *Audit Staff Qualifications*

Review the biographical data and interview the management staff of the audit department to determine their qualifications for their delegated responsibilities.

5. *Content and Utilization of the Audit Frequency and Scope Schedule*

Review the organization chart(s) and the bank's chart of accounts to determine the adequacy of the audit program.

6. *Audit Department Participation in Systems Design Projects*

Determine through interview of the auditor and appropriate staff members, and documentation review, the department's role in automated and/or manual systems design.

7. *Audit Manual*

Review the audit manual(s) and associated internal control questionnaires to determine the sufficiency of the prescribed procedures for the accomplishment of the objectives.

8. *Maintenance of Audit Records*

Review a sample of the audit reports and associated workpapers to determine compliance with prescribed procedures and proper documentation.

9. *Audit Department's Formal Reporting Procedures*

Review all auditor's reports to the board of directors (audit/examining committee) and a representative sample of the departmental and/or functional reports; consider their distribution and follow-up procedures; determine how effectively the audit department responsibility is discharged.

10. *Use and Effectiveness of Audit Computer Programs*

Interview the auditor and/or the appropriate staff members regarding the use of

the computer and access to the files for audit purposes.

EXTERNAL AUDITORS

Where certified public accountants or consulting firms have been engaged by the bank for statement certification, operational reviews, or appraisal of the audit function, review the most recent reports and management letters.

REGULATORY EXAMINATIONS

Review the most recent examination report and interview the auditor to determine his or her responsibilities in this area.

GENERAL

1. Review the following items with appropriate bank management or prepare a memorandum to other examining personnel for use in reviewing with management—
 - a. the adequacy of the internal audit program;
 - b. instances where the internal audit department has failed to carry out the audit program; and
 - c. outstanding internal/external audit report comments.
2. Prepare comments to be included in the report of examination.
3. Prepare a memorandum and update the workpapers with any information that will facilitate future examinations.

Review the documentation as instructed in the examination procedures section to answer the following audit function questions. Where appropriate, supporting documentation and pertinent information should be retained or noted under comments.

ORGANIZATIONAL STRUCTURE OF THE AUDIT DEPARTMENT

1. Has the board of directors delegated responsibility for the audit function? If so, to whom?
2. Has the board of directors established an audit committee?
 - a. Is it comprised solely of outside directors?
3. Are the members of the audit committee qualified for their particular responsibilities?
4. Does the audit committee meet with and review reports issued by the auditor? If so, how often?
5. Are the audit committee meetings with the auditor closed to bank personnel?
6. Do the minutes of the audit committee indicate an appropriate interest in the activities and findings?
7. Does the auditor report to the board of directors, the audit committee, or an executive officer sufficiently high in the bank's hierarchy? If so, which one and, if not, to whom?

INDEPENDENCE OF THE AUDIT FUNCTION

8. Is the audit department functionally segregated from operations in the organizational structure?
9. Does the audit committee review and/or approve the budget and salary of the auditor? If not, who does?
10. Are the reporting procedures of the auditor independent of the influence of any operating personnel?
11. Has the audit staff been relieved of responsibility for conducting continuous audits?
12. Has the audit department been relieved of

responsibility for maintaining duplicate records?

13. Do the responsibilities of the audit staff exclude any duties to be performed in lieu of operating personnel, such as preparation or approval of general ledger entries, official checks, daily reconcilements, dual control, etc.?

AUDITOR'S QUALIFICATIONS

14. Are the auditor's academic credentials comparable to other bank officers who have major responsibilities within the organization?
15. Is he/she certified (or in the process of becoming certified) as a chartered bank auditor, certified internal auditor, or certified public accountant? If yes, which one(s)?
16. Is his/her experience in both auditing and banking comparable both in quality and in duration to that required of the officers assigned major responsibilities?
17. Does he/she communicate and relate well with all levels of personnel?
18. Does the auditor demonstrate a commitment to continuing education and a current knowledge of the latest development in banking and auditing technology?
19. Is the auditor dedicated to the standards and ethics of his/her profession (such as those published by the Bank Administration Institute, the Institute of Internal Auditors, and the American Institute of Certified Public Accountants)?

AUDIT STAFF QUALIFICATIONS

20. Is the audit staff sufficient in number to perform its tasks adequately?
21. Is the staff adequately experienced in auditing and banking?
22. Are members of the staff experienced in specialized areas, such as EDP, foreign exchange trading, trust, and subsidiary activities of the bank?
23. Is there a formal audit training program in effect?

24. Is the number of unfilled vacancies on the audit staff considered reasonable?
25. Is the amount of audit personnel turnover acceptable?
26. Does management have plans to improve its audit capability, if needed?

CONTENT AND UTILIZATION OF THE AUDIT FREQUENCY AND SCOPE SCHEDULE

27. Is the audit program formalized and therefore on record as a commitment that can be analyzed and reviewed?
28. Are all important bank functions and services identified as subjects of the audits?
29. Does the audit program include procedures necessary to assure compliance with the Federal Election Campaign Act and the Foreign Corrupt Practices Act?
30. Does the internal audit department have access to all reports, records, and minutes?
31. Is the program periodically reviewed, where necessary, to adapt it to changing conditions?
32. Does the frequency and scope schedule require approval by the audit committee, the board of directors, regulatory authorities, or others?
 - a. If so, by whom and has such approval been obtained?
33. Does the frequency and scope schedule comply with state statutory requirements, if any, of internal audits, including minimum audit standards?
34. Does the auditor periodically report his/her progress in completing the frequency and scope schedule to the board's audit committee?
 - a. If not to the board's audit committee, to whom?
 - b. Does the committee approve significant deviations, if any, in the original program?
35. Does the auditor prepare a time budget?
 - a. Are budgeted versus actual time analyses used as a guide in forward planning?
36. Does the depth of coverage appear to be sufficient?
37. Are different entry dates and time periods between reviews scheduled so as to frustrate reliable anticipation of entry dates by auditees?
38. Is the bank's possession of all assets owned or managed in fiduciary capacities subjected to verification?
39. Are controls on opening and closing general ledger and subsidiary accounts adequate and is the auditor formally advised of any changes?
40. If the bank has automated systems, does the program call for the application of independently prepared computer programs that employ the computer as an audit tool?
41. Will the audit staff examine the documentation of all bank systems and produce their own documentation?
42. Are all service-related activities not specifically manifested in general ledgers accounts subject to adequate periodic review (for example, supervisory regulations, security, vacation policy, purchases, traveler's checks, and safekeeping)?
43. Will appraisals of administrative control be made for each function, yielding audit comments and suggestions for improvements of operational efficiency?

AUDIT DEPARTMENT PARTICIPATION IN SYSTEMS DESIGN PROJECTS

44. Is there a formal or informal procedure for notifying the auditor of contemplated new systems or systems modifications in the early planning stages?
45. Is the auditor a member of an executive systems planning or steering committee?
 - a. If not, does the auditor have access to and review the minutes of such committees?
46. Does an audit representative review the activities of systems design teams for audit and internal control requirements?
 - a. Is the specialized training and experience of the audit staff sufficient to support effective reviews?
47. Does the audit department avoid over-participation in systems design, modification, and conversion?
48. Is the auditor's "sign-off" on new or modified systems restricted to control and audit trail features?

AUDIT MANUAL

49. Has responsibility for the establishment and maintenance of the audit manual been clearly assigned?
50. Does the audit manual require approval by the board of directors, the audit committee, or others?
 - a. If so, has such approval been obtained?
51. Is the content of the audit manual independent of adverse influence of other interests, such as operating management or independent CPAs?
52. Is the audit manual current, and are procedures for keeping the manual current adequate?
53. Does the audit manual contain the scope and objective of each audit?
54. Does it provide for valid deviations from audit procedures to be officially approved by audit management?
55. Do audit procedures provide for the follow-up of exceptions noted in previous audits?
56. Does it prescribe that each audit procedure be cross-referenced to the appropriate audit workpapers?
57. Must an auditor initial each program step as testimony of his/her performance?
58. Does it prescribe that full control be established at the time of entry over the records selected for audit?
59. Is proof of subsidiary to control records required?
60. Are subsidiary direct verification programs covering all forms of customer deposit, loan, safekeeping, collateral, collection, and trust accounts included?
61. Are flow charts called for as evidence of thorough analytical auditing?
62. Do the procedures employ scientific sampling techniques with acceptable reliability and precision?
63. Does the audit manual provide for the resolution of exceptions and deficiencies?
64. Does the audit manual contain provisions for report format and content and an expression of the opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
65. For each audit, do audit procedures provide for a documented method of assuring audit management that a proper study and evaluation of existing internal controls has been made, such as an internal control questionnaire or memorandum?
66. Does the audit manual contain a provision for a review and update of the procedures for each audit, where required, upon its completion?
67. Does the audit manual make provision for the maintenance of a permanent file for audits conducted?
68. Does the audit manual contain provisions for the formal, standardized preparation and maintenance of workpapers?
69. Are applicable statutory and regulatory requirements included in the audit procedures?

MAINTENANCE OF AUDIT RECORDS

70. Are workpapers arranged and maintained for filing and reference in—
 - a. the current file and
 - b. the permanent file?
71. Is a reasonable record retention schedule and departmental index maintained for audit records?
72. Are audit procedures being complied with during each audit?
73. Do the workpapers contain evidence of all significant deviations from audit procedures with the approval of audit management?
74. Are procedures for preparing and maintaining workpapers being adhered to?
75. Do workpapers contain a copy of the audit report; an adequate index; an internal control questionnaire; audit procedures; and other appropriate material?
76. Are workpapers numbered, indexed, and cross referenced to audit procedures and the workpaper index?
77. Is each workpaper dated and initialed by the preparer?
 - a. Are sources of data clearly shown?
 - b. Are tick marks explained?
78. From the workpapers, can it be determined how various sample sizes were determined, judgment or scientific, including range and confidence level?
79. Do workpapers contain evidence that supervisory personnel of the audit department have reviewed the workpapers and resultant findings?
80. Are all significant and/or unresolved excep-

tions noted in workpapers required to be included in the report?

81. Are applicable statutory and/or regulatory requirements being complied with?

AUDIT DEPARTMENT'S FORMAL REPORTING PROCEDURES

82. Does the auditor submit formal reports?
a. If so, to whom?
83. Do the reports convey to the reader the auditor's general observation of the condition of the operation of the department or function?
a. Do they adequately reflect the scope of the audit?
b. Do they contain an opinion of the auditor regarding the adequacy, effectiveness, and efficiency of internal controls?
c. Do they call for a prompt response, where appropriate?
84. With regard to audit exceptions and recommendations, is the method of resolving differences of opinion between audit and operating management effective?
85. Does the auditor maintain a formal record of all audit reports that contain unresolved recommendations and exceptions?
86. Are exceptions and recommendations generally resolved within 90 days?
87. Are audit reports submitted promptly?
88. Are responses received promptly?

USE AND EFFECTIVENESS OF AUDIT COMPUTER PROGRAMS

89. What audit computer programs are used and what are their purposes?
90. Is there a member of the audit staff qualified to write and/or appraise the quality of audit computer programs?
91. Is the auditor satisfied that he or she has sufficient "free access" to the computer files?
92. Are audit programs run on request?
93. Do direct verification programs allow the auditor flexibility in selecting the criteria to be used in determining the sample?
94. Have procedures been established for the development and maintenance of documentation for audit computer programs?
a. Are they adhered to?

95. Are changes to audit programs controlled?

EXTERNAL AUDIT ACTIVITIES

96. Where state, federal, or supervisory regulations or stock exchange listing require an independent CPA audit, did the bank comply?
a. If so, was the opinion rendered by the accounting firm unqualified?
b. If not, has the auditor taken appropriate action in the resolution of any deficiencies?
97. Does the bank policy prohibit loans to its external auditor or the engagement of an external auditor who is a stockholder?
a. If not, has the board considered the materiality of any existing transactions regarding the auditor's independence?
98. Has an external auditor been engaged to perform special reviews of specific departments or areas of the bank since the previous examination?
a. If deficiencies were cited, have they been corrected?
99. Has the same public accounting firm been engaged for the prior two years? If not, obtain a reason for change.
100. Have management letters from the external auditors or other reports from consultants been presented to management since the last examination?
101. Do deficiencies in management letters receive appropriate attention?
102. Are the notes pertaining to the financial statements reviewed for any information that may allude to significant accounting or control problems?
103. Does the report of examination and/or the management letter submitted by the public accounting firm comprehensively define the scope of the examination conducted?

REGULATORY EXAMINATION ACTIVITIES

104. Does the internal audit department have access to the examination reports?
105. Does it investigate the reasons for adverse comments and recommendations in the examination reports?
106. Does it monitor the progress in dealing with these comments and recommendations?

INTRODUCTION

Under the Federal Reserve System Surveillance Program (the program), financial data are monitored on an ongoing basis. Information generated through the surveillance process is used to monitor the financial condition of banks between examinations, assist in setting examination schedules, and allocate supervisory or examination resources to institutions with deteriorating financial conditions.

The program consists of three components:

1. *Surveillance screen of bank financial data.* A process that identifies banks that may have financial weaknesses or deficiencies is conducted at the Board and referred to as “screening.”
2. *Analysis based on the Uniform Bank Performance Report (UBPR).* This is used to spot trends and changes in banks’ financial conditions and to determine if companies identified by the screening effort require further review. The analysis is performed by Reserve Bank analysts and examiners.
3. *Corrective action and follow-up.* These efforts ensure that identified problems are monitored until they can be corrected or resolved, and are performed by the Board and Reserve Banks.

ROLES IN THE EXAMINATION PROCESS

The program has two important roles in the examination process. The examiner can use the program to help identify weak or deteriorating banks, which can then be scheduled for targeted, limited-scope, or full-scope examinations. The program can also be used to begin preparing for an examination before arriving at a bank.

CAMELS Rating Updates

Reserve Bank personnel are required to update a CAMELS¹ rating for any state member bank

1. CAMELS is an acronym that describes the system used to rate the condition of banks. It stands for Capital adequacy, Asset quality, Management/administration, Earnings, Liquidity/funds management, and Sensitivity to market risks.

whenever a state examination report, an in-house review, financial reports, special monitoring reports, or other information indicates that a revision is warranted.

UBPR Analysis

The UBPR can be used to prepare preliminary evaluations of capital, asset quality, earnings, and liquidity before the examiner arrives at the bank to conduct an examination. If the initial evaluation of these areas is satisfactory, the examiner can allocate resources to other areas needing greater on-site review time, such as management, supervisory-report accuracy, or legal compliance. The UBPR analysis may also help the examiner identify areas requiring special attention during the examination by revealing declining financial trends or indicating bank financial positions that could lead to problems.

Review of Surveillance Screens

The examiner should review the Board’s screening results before arriving at the bank to determine whether the bank has been identified as an exception. If so, analyses conducted by Reserve Bank analysts should be reviewed, along with information available from Board staff. In some cases, consultation with surveillance or other supervision staff may be appropriate. The goal of all these activities is to help the examiner identify areas to focus on during the examination.

SURVEILLANCE OF STATE MEMBER BANKS

The program consists of three phases: (1) generating and reviewing an exception list of organizations meeting exception criteria identified by computer models (such banks are referred to as having “failed the screen”), (2) preparing an analysis of institutions on the exception list that discusses the factors responsible for the bank appearing on the exception list, and (3) developing a suitable supervisory response, including possible corrective action that addresses problems first identified through the surveillance process.

Exception List

Bank surveillance is conducted quarterly for all banks for the reporting periods ending on the last days of March, June, September, and December. Board staff initiates the surveillance process by subjecting all banks, regardless of charter or CAMELS rating, to the screen. State member banks that fail the screen and that had a composite rating of 1, 2, or 3 at their last examination are placed on the exception list. Banks rated 4 and 5 do not appear on the list because they have already been identified as problem institutions subject to increased examination frequency, monitoring, and supervision. The Board sends an exception list to the Reserve Banks, which submit written analyses of the banks on the list to the Board. The exception list is available both on-line and in hard copy.

The exception list is based on two econometric models that are run at the Board and that together constitute the System to Estimate Examination Ratings (SEER),² and on an investment activities screen.

SEER—The Rating Model

Call report information based on the most recent two quarters is used to estimate an econometric model that, in turn, is used to estimate a CAMELS rating for the bank. This estimated CAMELS rating, called the SEER rating, helps identify banks whose financial conditions have changed between on-site examinations.

SEER—The Risk-Rank Model

Historic information on bank failures is used to estimate an econometric model, which then estimates a measure of risk for the bank. The econometric model determines the financial factors typical of banks that have failed in the past. The model then uses the most recent eight quarters of call report information to determine if any of the reporting banks exhibit the same characteristics as banks that have failed during these same eight quarters. This determination is

expressed as a percentage representing, in general terms, the probability that the bank would fail if the economic conditions of the previous eight quarters were to occur again.

For banks to appear on the exception list as a SEER exception, they must meet the criteria in table 1:

Table 1. State Member Bank Exception-List Criteria

<i>Most Recent On-Site CAMELS Rating</i>	<i>Rounded SEER Rating</i>	<i>or SEER Risk Rank</i>
1	3 or worse	2% or higher
2	3 or worse	2% or higher
3	4 or worse	3% or higher

Investment Activities Screen

The investment activities screen identifies state member banks with significant unrealized securities losses relative to tier 1 capital. For banks to appear on the investment activities exception list, they must have a CAMELS rating of 1, 2, or 3 with a ratio of total unrealized securities depreciation to tier 1 capital of –20 percent or worse *and* a tier 1 leverage ratio, adjusted for total securities depreciation, of less than 5 percent.

Review of Bank Exception List and Reserve Bank Analysis

The exception list provides a record of banks that failed the screens and helps track Reserve Bank conclusions on the reasons a bank failed the screens. Each Reserve Bank prepares a report of each bank on the exception list. In their review, Reserve Banks are specifically requested to perform the following bank surveillance procedures.

- Review each state member bank in their district identified on the exception list to determine if its financial condition has worsened significantly since the bank’s last examination.

2. The SEER methodology is described in detail in “FIMS: A New Monitoring System for Banking Institutions,” *Federal Reserve Bulletin*, January 1995. The acronym FIMS was substituted in the article for the acronym SEER; both acronyms describe the same system.

- Prepare a written analysis for all banks on the exception list. This Reserve Bank analysis is to include the following sections:

- *Heading*, including the bank's name, location, total assets, and CAMELS rating; comparable parent holding company information (when applicable); the SEER rating and risk rank; the ratio of total securities depreciation to tier 1 capital (when applicable); the leverage ratio adjusted for total securities depreciation (when applicable); any surveillance rating assigned within the Reserve Bank; and the Reserve Bank analyst's name.
- *Background*, including a summary of prior reports prepared as a result of the surveillance process (surveillance results) and for investment activities exceptions, a brief summary of the investment objectives, and management oversight of the investment process.
- *Analysis*, detailing the current period's surveillance results and highlighting key changes in financial results during the most recent quarter and/or since the most recent examination. In particular, this analysis should explicitly discuss whether the financial factors identified as being responsible for the bank's appearance on the exception list present any cause for supervisory concern. Any areas for which the current period's surveillance results are believed to be misleading or inaccurate should be detailed in this section. For investment activities exceptions, the analysis should include a summary of the bank's investment strategy and portfolio, the ability and intent of the bank to hold securities with unrealized losses, the susceptibility of the portfolio to further depreciation, hedging strategies (if any), liquidity and capital positions, funding sources, management's ability to understand and manage the risks inherent in the investment portfolio, and the overall impact of the securities depreciation on the financial condition of the bank.
- *Conclusion*, summarizing primary reasons for deterioration in the bank's condition.
- *Corrective action*, detailing supervisory follow-up actions resulting from the current period's surveillance results. If no further actions are to be taken or recommended, the reason for this decision and

the date and scope of the next scheduled examination must be provided.

- *Sign-off*, documenting approval of the officer in charge of state member bank supervision and the officer in charge of state member bank surveillance, and for investment activities exceptions, the capital markets coordinator.
- Submit the written analyses within one month after receipt of the exception list to the manager of the Surveillance Section at the Board.
- Beginning with the March 31, 1996, surveillance cycle, if a written analysis has already been provided for an exception-list bank during one of the previous two quarters and there has not been a meaningful change in the bank's condition since this analysis, Reserve Banks are not required to prepare an additional write-up. In these instances, Reserve Banks should reference the prior analysis in their quarterly letter to the Federal Reserve Board's Banking Supervision and Regulation Surveillance Section and provide an update on the status of a supervisory action or strategy outlined in the earlier analysis. Furthermore, if there is an open or completed examination with the same "as-of date" as the current surveillance cycle for an exception-list bank, a written analysis is not required if the scope of the examination includes an analysis of the factors causing the bank to be placed on the exception list. These factors include a rating screen (SEER rating and risk rank) and an investment activities screen (depreciation/tier 1 capital and adjusted tier 1 leverage).

In addition, for state member banks meeting the criteria specified in table 2, or when the Reserve Bank determines that an on-site presence is necessary to complete the investment activities analysis, there is a presumption that the Reserve Bank will conduct an on-site examination of these institutions within 45 days after the written analyses are due. This requirement may be satisfied through a targeted (rather than full-scope) visitation/examination that focuses on the factors identified in the surveillance results.

Table 2 uses either (1) a combination of the rounded SEER rating and the SEER risk rank or (2) the rounded SEER rating alone to determine whether a bank is presumed to require an on-site examination within 45 days. For example, any bank that was rated 1 at its most recent examination and has a rounded SEER rating of 3 or

Table 2. Criteria for On-Site Examination within the Next 45 Days

<i>Most Recent On-Site CAMELS Rating</i>	<i>Rounded SEER Rating</i>	<i>and SEER Risk Rank</i>	<i>or Rounded SEER Rating</i>
1	—	—	3 or worse
2	3 or worse	10% or higher	4 or worse
3	4 or worse	10% or higher	5 or worse

worse, regardless of its SEER risk rank, qualifies for an on-site examination. To qualify for an on-site examination, a 2-rated bank must have either (1) a rounded SEER rating of 3 or worse and a SEER risk rank of 10 percent or higher or (2) a rounded SEER rating of 4 or worse, regardless of the SEER risk rank.

For SEER exceptions, if the Reserve Bank has reason to believe that an on-site examination of a particular bank is not warranted within

45 days after the written analyses are due, the officer in charge of state member bank supervision must send a written request for a waiver from this requirement to the assistant director of the Surveillance Section at the Board. Waiver requests are due at the Board within one month after the SEER results are received and must fully demonstrate that either (1) the findings of the SEER models are not indicative of the bank’s financial condition or (2) the bank’s most recent examination thoroughly reviewed the factors responsible for the deteriorating surveillance results and demonstrated that they are not a cause for supervisory concern or have been adequately addressed by existing or proposed corrective actions.

Corrective Action and Follow-Up

Corrective action associated with newly identified problems should be initiated by the Reserve Bank as soon as possible. Follow-up action may include correspondence or meetings with the bank’s management, or an on-site examination. Problem situations are closely monitored by surveillance and supervision staff at the Board and the Reserve Banks until they have been resolved.

Reserve Bank Surveillance Program

Examination Objectives

Effective date November 1995

Section 1020.2

1. To identify major changes in the financial condition of the bank between examinations.
2. To assist in determining the scope of the examination and the priority of work to be performed.
3. To check the validity of the data being reported by the bank.
4. To investigate areas where an in-depth review is indicated.
5. To explore other areas where information is not available through normally reported data.

Reserve Bank Surveillance Program

Examination Procedures

Effective date March 1984

Section 1020.3

1. Obtain any surveillance screening exception reports, or other Reserve Bank or Board prepared analysis reports, that have been generated for the bank.
2. Review the reports obtained in step 1 and discuss with surveillance staff, if necessary, for clarification or for further background information.
3. If a pre-examination analysis has not been prepared, create one from information contained in the bank performance report, current call report, and previous examination report. This analysis should be considered when determining the scope of the examination, and when making staffing decisions.
4. Follow up on unusual aspects revealed in the surveillance screening reports, analysis reports, or on newly obtained data significantly different from prior information.
5. Perform validity checks necessary to ensure the quality of reported data. This would include such normal examination procedures as validating call report information and confirming the accuracy and soundness of past-due and accrual accounting practices.

INTRODUCTION

Workpapers are the written documentation of the procedures followed and the conclusions reached during the examination of a bank. Accordingly, they include, but are not necessarily limited to, examination procedures and verifications, memoranda, schedules, questionnaires, checklists, abstracts of bank documents and analyses prepared or obtained by examiners.

The definition of workpapers, their purpose, and their quality and organization are important because the workpapers as a whole should support the information and conclusions contained in the related report of examination. The primary purposes of workpapers are to—

- organize the material assembled during an examination to facilitate review and future reference.
- aid the examiner in efficiently conducting the examination.
- document the policies, practices, procedures and internal controls of the bank.
- provide written support of the examination and audit procedures performed during the examination.
- document the results of testing and formalize the examiner's conclusions.
- substantiate the assertions of fact or opinion contained in the report of examination.

They also are useful as—

- a tool for the examiner-in-charge to use in planning, directing, and coordinating the work of the assistants.
- a means of evaluating the quality of the work performed.
- a guide in estimating future personnel and time requirements.
- a record of the procedures used by the bank to assemble data for reports to the Board of Governors of the Federal Reserve System.
- a guide to assist in the direction of subsequent examinations, inquiries and studies.

The initial step in preparing workpapers is to review, where available, the applicable sections of supporting data prepared during the prior examination. When reviewing prior workpapers, the examiner should consider the data prepared in each area for—

- information that is of a continuing or permanent nature.
- guidance in preparation of workpapers for the current examination.
- an indication of changes or inconsistencies in accounting procedures or methods of their application since the last examination.

Accumulation of relevant documentation consistent with prior examinations, however, is often insufficient. Workpapers should be prepared in a manner designed to facilitate an objective review, should be organized to support an examiner's current findings and should document the scope of the current examination. Minimum content necessary for each section of workpapers includes:

Source of Information—This is important, not only in identifying the bank, but also in identifying the preparer. In subsequent examinations, the preparer should be able to readily determine the bank personnel from whom the information was obtained during the previous examination as well as the examiner who prepared the workpapers. Accordingly, each workpaper should include—

- bank name and subdivision thereof, either functional or financial.
- statement of title or purpose of the specific analysis or schedule.
- specific identification of dates, examination date and work performance date.
- initials of preparer and initials indicating review by the examiner designated to perform that function. Although appropriate use may be made of initials, the full names and initials of all examiners should appear on a time and planning summary or on an attachment to the file to facilitate future identification.
- name and title of person, or description of records, that provided the information needed to complete the workpaper.
- an index number identifying the workpaper and facilitating organization of the workpaper files.

Scope of Work—This includes an indication of the nature, timing and extent of testing in application of examination and audit procedures. It also includes the examiner's evaluation of and reliance on internal and external audit

procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as an examination procedure or a questionnaire, a reference to the appropriate workpaper will be sufficient.

Conclusions—The examiner should develop conclusions, in accordance with the examination objectives, with respect to the information obtained, documentation provided and the results of the examination and audit procedures performed. Such conclusions provide the basis for information contained in the report of examination.

To develop workpapers that have the qualities of clarity, completeness and conciseness, adequate planning and organization of content are essential. Therefore, before the workpaper is prepared, the examiner should determine the following:

- What examination objective will be satisfied by preparing the analysis or workpaper?
- Can preparation of the analysis be avoided by testing the bank's records and indicating the nature and extent of testing in an examination or an audit procedure or by comment on a related schedule or another supporting document?
- Is the analysis necessary to support the information in the report of examination?

Subsequent to the determination that an analysis is required, but before initiating preparation, the examiner should decide if—

- previous examination analyses can be adapted and carried forward to the current examination.
- the analysis can be prepared by an internal auditor or other bank personnel.
- the format of the analysis may be designed in a manner to facilitate its use in future examinations.

Once it has been determined that preparation of an analysis is required, the examiner should consider the following techniques that promote clarity of workpaper preparation:

- Restrict writing to only one side of the paper.
- Use a standard size sheet of paper large enough to avoid overcrowding.

- Condense information for simplicity.

Frequently, time can be saved by carrying forward workpapers from one examination to the next. Thus, when laying out an analysis that might be repeated in future examinations, the examiner should arrange it in a manner to facilitate future use. For example, extra columns may be left blank within an account analysis displaying little activity for insertion of transaction information during future examinations. In such a situation, appropriate space (boxes and column headings) should be provided for the signature or initials of the preparer and reviewer during each examination. When a workpaper is removed from one examination file and carried forward, a notation should be made in the file from which the paper is extracted. This is important in the event workpapers applicable to a particular examination are needed several years after the completion of the examination.

INITIAL PREPARATION BY OTHERS

Although all items included in the report of examination should be supported by workpapers, their preparation may not always require original work by the examiner. Frequently, arrangements can be made for bank personnel, including internal auditors, to prepare workpapers for examination use or to make available papers prepared by them as part of their regular duties. Examples include outstanding checklists, lists of outstanding certificates of deposit, schedules of employee borrowings, and debt maturity schedules. The extent to which examiners can utilize analyses and data prepared by bank personnel increases the efficiency with which examination procedures are completed.

As part of the initial examination planning process, arrangements should be made with appropriate bank management for the timely completion of bank-prepared data and information. The coordinating bank officer(s) must understand what information is being requested and why it is being requested, in order to avoid confusion and unnecessary regulatory burden. Arrangements, however, may have to be made for the bank to supply supporting details or other schedules or items to comply with the requests.

Upon receipt of bank-prepared analyses, an examiner should review the documents for over-

all completeness and note the date of receipt. This facilitates future planning and provides a ready reference as to which analyses have been received from the bank at any given point during the examination. Also, all bank-prepared workpapers should be tested and the nature and extent of testing performed by the examiner should be indicated on the papers.

INITIAL APPROACH IN WORKPAPER PREPARATION

The initial approach in preparing workpapers that support balances in the statement of condition is quantitative. In using this approach, the examiner obtains an analysis of the composition of the account balance as of the examination date. This inventory of the composition may be represented by a trial balance of loans, a listing of outstanding official checks, a listing of individual deposit accounts, or other similar items. Only after determining the composition and insuring that the total agrees with the bank's records is the examiner in a position to perform examination procedures and to arrive at a conclusion about the overall quality of the items comprising the balance.

For certain analyses, however, it is preferable to include account activity (transactions) in the workpapers. Typical examples of such analyses are those of bank premises and equipment and of reserve for possible loan losses. The format for reserve for possible loan losses should include beginning balances (prior examination ending balances), provisions for loan losses, collections, charge-offs, other transactions (transfers to/from undivided profits) and ending balances as of the examination date.

CONTROL AND REVIEW

All examiners assigned to an examination should insure that workpapers are controlled at all times while the examination is in progress. For example, when in the bank's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the bank. In addition, information relating to the extent of tests and similar details of examination proce-

dures should not be made available to bank employees.

In cases where customary examination practices are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness requires that there be no open items, unfinished operations or unanswered questions in the workpapers at the conclusion of the examination.

The clarity of workpapers should be such that an examiner or Federal Reserve official unfamiliar with the work could readily understand it. Handwritten commentaries should be legible, concise and should support the examiner's conclusions. Descriptions of work done, notations of conferences with bankers, conclusions reached and explanations of symbols used should be free from ambiguity or obscurity. Excessive use of symbols usually can be avoided by expanding a comment to include the nature and extent of work performed instead of using separate symbols for each portion of the work performed. In addition, instructions to assisting personnel concerning standards or workpaper content are necessary to ensure that they will meet the quality standards of the Federal Reserve. When workpapers have the necessary qualities of completeness, clarity, conciseness and neatness, a qualified reviewer may easily determine their relative value in support of conclusions and objectives reached. Incomplete, unclear or vague workpapers should, and usually will, lead a reviewer to the conclusion that the examination has not been adequately performed.

REVIEW PROCEDURES

Experienced personnel must review all workpapers prepared during an examination. Usually that review is performed by the examiner-in-charge, although in some cases, the examiner-in-charge may designate other experienced personnel to perform an initial review. An overall review is then performed by the examiner-in-charge. The two primary purposes of a review of workpapers by senior personnel are to determine that the work is adequate given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. The timely review of workpapers and subsequent discussion of them with the individual who prepared them also is one of the more effective procedures for on-the-job training.

Normally, the review should be performed as soon as practicable after the completion of each work area. This review ideally occurs at the bank's office so that if the need for obtaining additional information arises or additional work is required the matter can be promptly attended to with minimum loss of efficiency.

When the review of workpapers is completed, the reviewer should sign or initial the applicable documents. Although all workpapers should be reviewed, the depth and degree of detail depends on factors such as:

- The nature of the work and its relative importance to the overall examination objectives.
- The extent to which the reviewer has been associated with the area during the examination.
- The experience of the examiners who have carried out the various operations.

Professional judgment must be exercised throughout the review process.

ORGANIZATION OF WORKPAPER FILES

Administration of an examination includes—

- organizing the workpaper files.
- delegating authority for completion of all applicable workpaper sections.
- reviewing and assembling the completed workpapers.

To ensure efficiency in locating information contained in the workpapers and completion of all necessary procedures, workpapers should be filed and indexed in a standard manner.

FILES

The file provides the organizational vehicle to assemble workpapers applicable to specific areas of the examination. Files might include detailed workpapers related to—

- management appraisal.
- overall conclusions about the condition of the bank.
- cash accounts.
- investments.

- loans.
- reserve for possible loan losses.
- bank premises and equipment.
- other assets.
- deposits.
- other liabilities.
- capital accounts and dividends.

Each individual file would normally include—

- related examination and audit procedures.
- detailed information and other documentation necessary to indicate the specific procedures performed, the extent of such procedures and the examiner's conclusions for the specific area.
- a summary, in comparative form, of the supporting general ledger balances with appropriate cross-references.

Judgment is required as to what the file should include on any specific examination. Lengthy documents should be summarized or highlighted (underlined) so that the examiner who is performing the work in the related area can readily locate the important provisions, without having to read the entire document. It also may be desirable to have a complete copy of the document in the file to support the summaries or answer questions of a specific legal nature.

Examples of documents that might be contained in the files are—

- a brief history and organization of the bank.
- organization charts of applicable departments within the bank.
- copies of, or excerpts from, the charter and bylaws.
- copies of capital stock certificates, debentures agreements and lease agreements.
- excerpts from minutes or contracts that are of interest beyond the current year.
- a chart of accounts and an accounting manual, if available, supplemented by descriptions of unique accounts and unusual accounting methods.
- lists of names and titles of the board of directors, important committees and relevant departmental personnel.

Indexing and Cross-Referencing

To promote efficiency and help ensure that all

applicable areas of an examination have been considered and documented, the use of an indexing system aids in the organization of workpaper files. A general outline or index including all examination areas provides a basis for organization to which a numbering or other sequential system can be assigned and applied to each workpaper file.

When all workpapers pertinent to a specific area of the examination have been completed, a cover sheet listing the contents of each file should be attached to the front to provide a permanent record for reference. This permits not only efficient location of a set of workpapers pertinent to a specific area of the examination (for example, cash or commercial loans), but also facilitates the location of a specific analysis (or other document) within the set.

Amounts or other pertinent information appearing in more than one place in the workpapers should be cross-referenced between the analyses. A notation on the index, including appropriate cross-referencing of those items removed or filed elsewhere, facilitates location of specific data and records and also helps to prevent inadvertent loss of documents. An example is the cross-referencing of net charge-offs obtained in the review of the reserve for possible loan losses to the amount approved in the board of director's minutes. Proper cross-referencing is important because it—

- serves as a means of locating work performed for a particular account or group of accounts.
- identifies the source of supporting amounts in a particular analysis.

- facilitates the review of the workpapers.
- helps in following the workpapers during the succeeding examination.

WORKPAPER RETENTION

Examiners should retain on a readily available basis those workpapers from—

- the most recent full-scope Federal Reserve examination.
- the most recent general EDP examination.
- examinations of banks requiring or recommended for more than normal or special supervisory attention (composite rating of 3, 4 or 5; consumer compliance rating of 3, 4 or 5; EDP departments rated 4 or 5; or those subject to administrative action such as civil money penalties) until such banks are no longer the subject of such scrutiny.
- examinations disclosing conditions that may lead eventually to more than normal or special supervisory attention, as described above, until the supporting workpapers are no longer appropriate.
- examinations disclosing conditions that lead, or may eventually lead, to a criminal referral or criminal investigation.

These guidelines are the minimum required retention period for workpapers; longer retention periods may be set by individual Reserve Banks.